

Proposed Bipartisan Legislation on Opportunity Zones and Qualified Opportunity Funds Would Extend the Investment and Gain Deferral Period By Two Years and Permit Investment in a Fund of Funds

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On September 27, 2023, H.R. 5761, the “Opportunity Zones Transparency, Extension and Improvement Act” was introduced as bipartisan legislation in the US House of Representatives.

Among other things, the **proposed legislation**, if enacted into law, would extend the investment and tax deferral period for capital gains that are invested in qualified opportunity funds (QOF) by two years (from December 31, 2026 to December 31, 2028) and permit

QOFs to be structured as a fund of funds.

Background

The 2017 Tax Act included in section 1400Z-2 a new tax incentive provision that was intended to promote investment in economically distressed communities, referred to as “Opportunity Zones.” Through this program, investors can achieve the following three significant tax benefits:

1. The deferral of gain on the disposition of property to an unrelated person generally until the earlier of the date on which the subsequent investment is sold or exchanged, or December 31, 2026, so long as the gain is reinvested in a QOF within 180 days (or 180 *deemed* days) of the property’s disposition;
2. The elimination of up to 15% of the gain that has been reinvested in a QOF provided that certain holding period requirements are met;**[1]** and
3. The potential elimination of tax on gains associated with the appreciation in the value of a QOF, provided that the investment in the QOF is held for at least 10 years.

An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Internal Revenue Service (IRS).

A QOF, in turn, is an investment vehicle that is established as either a domestic partnership or a domestic corporation for the purpose of investing in eligible property that is located in an

Opportunity Zone and uses investor gains from prior investments as a funding mechanism.

To become a QOF, the entity self-certifies itself. The entity must meet certain requirements, in particular a general requirement that at least 90% of its assets be “qualified opportunity zone property” used within an Opportunity Zone, but no approval or action by the IRS is required. To self-certify, the entity completes IRS Form 8996, and then attaches that form to the entity’s timely-filed federal income tax return for the taxable year (taking into account extensions).[2]

The QOF rules have unique peculiarities that can affect estate planning. Notably, gifts of QOF interests will generally be “inclusion events” (triggering a recognition of previously deferred capital gains, and the termination of the relevant holding periods for QOF investment purposes) unless the gift or other transfer is made to a “grantor trust.”[3]

The Proposed Legislation

The proposed legislation would do the following:

1. Extend the investment and gain deferral period for two years (until December 31, 2028).

The proposed legislation would extend the investment and gain deferral period for investments in QOFs from December 31, 2026, to December 31, 2028. This amendment applies to all amounts invested after December 22, 2017. According to the **Legislative Explanation**, which accompanied the introduction of the proposed legislation, the rationale for this extension is that it took the US Treasury Department nearly two years to issue final regulations governing Opportunity Zones, during which time many investors

and stakeholders stayed on the sidelines awaiting the promulgation of clear rules. Thus, extending the investment and deferral period by an equal amount of time will help investors and communities fully utilize this tool as Congress intended.

2. Reinstate and expand reporting requirements.

The original legislation that created Opportunity Zones included reporting requirements that were ultimately omitted from the 2017 Tax Act. According to the Legislative Explanation, these requirements will promote transparency, ensure the program is operating as intended, and allow for the tracking of long-term outcomes in designated communities.

3. Early sunset to apply to Opportunity Zones that are not “impoverished.”

While the vast majority of census tracts designated as Opportunity Zones are impoverished areas based on census data, a small number of non-low-income communities were designated as Opportunity Zones. The proposed legislation would sunset the Opportunity Zone designation for any tracts with a median family income (MFI) at or above 130% of national MFI, and provide states with flexibility to further sunset additional tracts. States would be able to replace the sunset tracts one-for-one with eligible high-need communities.

4. Permit investments through a Fund of Funds.

The proposed legislation would allow Qualified Opportunity Funds to be organized as a "fund of funds" that may invest in other QOFs. This, until now, has not been permitted.

More specifically, the definition of a QOF would be expanded to include “any qualified feeder fund.” The proposed legislation defines a “qualified feeder fund” to mean any investment vehicle

that invests in a QOF if:

(A) such investment vehicle is organized as a domestic partnership for the purpose of investing in one or more corporations or partnerships that is a QOF,

(B) all investments in the investment vehicle are made in cash, and

(C) not less than 95% of the assets held are equity investments in corporations or partnerships that are QOFs as measured (1) on the last day of the first six-month period of the taxable year of the feeder fund, and (2) on the last day of the tax year of the feeder fund.

The Legislative Explanation posits that this will permit smaller communities and projects to receive QOF financing.**[4]**

5. Other Items.

The proposed legislation would also provide operating support and technical assistance to high-poverty and underserved communities through a “State and Community Dynamism Fund.” It would also permit certain “brownfield tracts” to qualify as Opportunity Zones if they have zero population and are adjacent to a currently designated Opportunity Zone tract.

The proposed legislation is very notable and mirrors the bipartisan (and bicameral) QOF legislation that was introduced in 2022 in both the House of Representatives and the Senate but ultimately stalled and was not enacted into law. Given everything that has transpired both on the world stage (*i.e.*, the extraordinarily tragic events in Israel) and on the domestic front since the introduction of the proposed legislation at the end of September, it remains to be seen when the House of Representatives will be able to turn its attention

back to this proposed legislation. But the prospect of a two-year extension of the tax deferral and other benefits to be derived from investing in QOFs is highly significant, as is likewise the proposed expansion of the definition of QOFs to permit investment in a fund of funds.

[1] This is accomplished through basis adjustments. Section 1400Z-2(b)(2)(B)(iii) provides that in the case of any investment in a QOF that is held for at least five years, the basis of such investment shall be increased by ten percent (10%) of the deferred gain. In addition, section 1400Z-2(b)(2)(B)(iv) provides for an additional five percent (5%) increase in the basis of the QOF investment if it is held by the taxpayer for at least seven years.

[2] The IRS Form 8996 and the instructions thereto are set forth at the following links: <https://www.irs.gov/pub/irs-pdf/f8996.pdf> and <https://www.irs.gov/pub/irs-pdf/i8996.pdf>.

[3] For additional details, see Kevin Matz, *How the Final Regulations on Qualified Opportunity Funds Come Out on Trust and Estate Related Issues*, 47-7 Estate Planning 3 (July 2020).

[4] These amendments would take effect on the date of enactment of the proposed legislation.