Opportunity Update: As major deadlines in the Opportunity Zone program pass, we dive into the benefits that still exist

BY BRANDI SMITH

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Going into a new presidential administration, one of the big concerns in the investment community was the future of the Opportunity Zone (OZ) program. It was created by the 2017 Tax Cuts and Jobs Act, which was passed under a Republican administration.

"These are uncertain times for any income tax laws. However, the OZ program was originally enacted with bipartisan support, and I'm not aware of any proposed discontinuation of the OZ program," said Chris Goodrich, partner at Houston-based law firm Crady Jewett McCully & Houren. "There has been Democratic interest in imposing more stringent reporting requirements for OZ investments, but it's not presently known what these more stringent requirements might be."

§§ 1400Z allows investors to defer, reduce, and in some cases, eliminate capital gains tax by investing in specified low-income areas designated as qualified Opportunity Zones (OZs). They must do so by reinvesting their capital gains in Qualified Opportunity Zone funds (QOFs).

State governors submitted their recommendations for OZ tracts, areas in need due to chronic unemployment, lower population density and economic disruptions, such as natural disasters. The result is more than 8,700 qualified tracts scattered around the country, including hundreds in Texas.

Chris Goodrich

A common question related to that list is whether it could change based on the results of the 2020 Census.

"Technically, the designation of a census tract as an Opportunity Zone expires after 10 years," said Goodrich. "But the final regulations provide that an investment in OZ property will retain its status through December 31, 2047, even though a census tract ceases to be classified as an OZ due to a future census."

The OZ program has incurred some other minor tweaks since the last update to it. The most significant change came by way of the COVID-19 relief packages, which resulted in several extensions of deadlines for QOFs and their investors, according to Goodrich.

First, he says, the IRS issued Notice 2020-23 on April 6, 2020. It extended

some investment deadlines until July 15, 2020. President Trump's declaring the COVID-19 pandemic a federal disaster also had an impact.

"This had the effect of placing the entire United States in a 'federally declared disaster' area and thereby extended the 31-month working capital safe harbor for QOF subsidiaries by up to an additional 24 months," Goodrich explained.

The IRS announced still further extensions in IRS Notice 2021-10 and Notice 2021-39. Though one significant deadline related to OZs just passed on March 31, there are still a number of tax benefits available to investors.

"The first tax benefit is a temporary deferral of tax on present capital gain (including the 3.8 percent net-investment income tax) if an amount equal to that gain is timely reinvested into a QOF (so-called 'deferred gain')," said Goodrich. "This deferral lasts until the earlier of (i) an 'inclusion event' or (ii) December 31, 2026."

The second tax benefit is a permanent 10 percent reduction in the rolled-over deferred gain if the electing taxpayer's holding period in their QOF reaches five years.

"Note that if an electing taxpayer fails to roll over his or initial gain into a QOF by December 31, 2021, that electing taxpayer will not be able to satisfy the five-year holding period (and thereby receive a 10 percent reduction in gain) before the 'drop dead' gain recognition date of December 31, 2026," Goodrich said.

Finally, if an electing taxpayer's holding period in his or her QOF interest reaches 10 years and that electing taxpayer so elects, the electing taxpayer is entitled to a permanent exclusion of any new gain.

"That means the gain in excess of the rolled-over deferred gain generated from the appreciation of the QOF investment, the 'excluded gain,'" said Goodrich.

For those who have not yet taken advantage of the unique investment possibilities that OZs present, Goodrich noted a couple things to watch going forward.

The 10 percent reduction in deferred gain will be lost if a taxpayer doesn't invest in an QOF by the end of 2021. Additionally, with each passing day, the first benefit (tax deferral on deferred gain) lessens.

Goodrich added that Democrats have expressed interest in increasing tax rates on long-term capital gains.

"If that happens, the first tax benefit noted above will become less valuable, but the third tax benefit noted above will become more valuable," he said.