

# Opportunity Zones: What Estate Planners Need to Know

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# What is a Qualified Opportunity Zone?

- Qualified Opportunity Zone (QOZ)
  - Section 1400Z of the Internal Revenue Code
  - Low-income census tracts
    - Nominated by state governors
    - Certified by the U.S. Treasury
- Nationally more than 8,700 QOZs have been designated!
- Utah has designated 46
- Nearly one-third of Utah's QOZs are in Salt Lake City
- For stats and maps:  
<https://opportunitydb.com/location/utah/>

# Tax Benefits

- Qualified TP (QTP) defers income recognition by “reinvesting” realized “eligible gain” in a Qualified Opportunity Fund (QOF)
  - QTP = indiv., corp., partnership, estate, or nongrantor trust
  - Initial basis in qualifying investment = zero
  - “Reinvestment” must occur within 180 days of realization event (event is day 1), so investment must follow realization
    - Special timing rule for pass-thru entities and owners
- Tracing of funds not required (contrast with IRC §1031)
- IRS position: “eligible gain” includes only short and long-term capital gain, as well as §1231 gain and unrecaptured §1250 gain
- Sale or exchange must be with unrelated party
  - 20% threshold for relatedness

# Tax Benefits (continued)

- Deferred gain not included in income till earlier of:
  - 12/31/2026 (paid by 4/15/2027 by calendar year TP)
  - Inclusion event (discussed below)
- Basis in investment increased to 10% of original investment at 5 years and to 15% at 7 years
- Post-investment appreciation tax free at 10 years upon taxable disposition if taxpayer elects to step-up basis to FMV
- Recognized income = lesser of (a) deferred gain or FMV of QOF interest (with valuation discounts?), less (b) basis
- Only investment of deferred gain eligible for tax benefits; non-gain investment treated separately
- Deferred gain retains character (e.g., short-term CG, etc.)

# Inclusion Events (not exhaustive)

- Following are examples of inclusion events:
  - Sale or exchange of all or a portion of a qualifying investment
  - Gift of qualifying investment (except to a grantor trust)
  - Receipt of distributed property (including \$) in excess of basis
  - Liquidation of the QOF
  - Liquidation of (or transfer of interest in) owner of a qualifying investment
- Following are not inclusion events:
  - IRC § 721 contribution of a qualifying investment (with one exception)
  - Devise or transfer of qualifying investment at death
  - Transfer of a qualifying investment by operation of law
  - Transfer of qualifying investment to a DRE (including a grantor trust)
    - Termination of grantor status other than by death is an inclusion event
- After 12/31/2026, inclusion events are not relevant to qualifying investments

# Example 1

- On 8/1/18, TP sells stock for \$15M (basis = \$5M). Amount realized is \$15M; LTCG realized is \$10M. Up to \$10M realized gain eligible for tax benefits if TP invests that amount in QOF by 1/27/2019
- If TP invests all \$15M in a QOF, only \$10M eligible for the tax benefits (“qualifying investment”). TP treated as having two separate investments in the QOF: \$10M qualifying investment; and a \$5M “nonqualifying investment”
- TP’s initial tax basis in qualifying investment is zero. On 8/1/2023 his basis will be \$1M. On 8/1/25, it will be \$1.5M. If TP sells the qualifying investment on or after 8/1/2028, he may elect to increase the basis of his qualifying investment to FMV

# Qualified Opportunity Fund

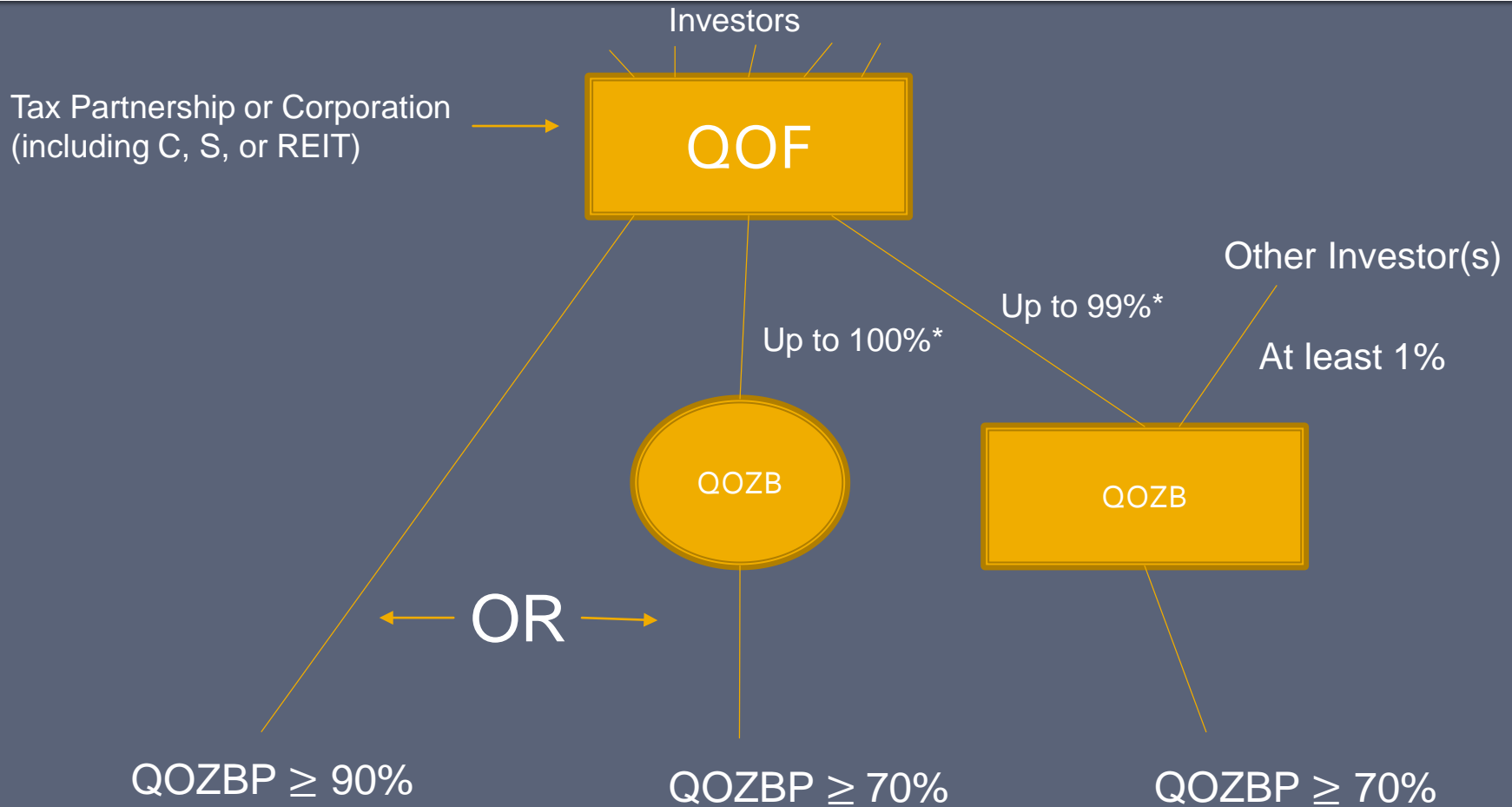
- Investment vehicle classified as corp. or partnership
  - SM LLC (disregarded entity) not allowed
- Organized to invest in QOZ property (QOZP)
- At least 90% of assets must be QOZP
  - Average as of end of 1<sup>st</sup> 6-months and yearend
  - Conventions apply for short years
  - Penalty for failure to comply (deficit \* IRC §6621(A)(2) underpayment rate)
  - 6-month safe harbor to deploy newly invested capital

# Qualified Opportunity Zone Property

- QOZP
  - QOZ stock in 1<sup>st</sup> tier corporate sub
  - QOZ partnership interest in a 1<sup>st</sup> tier sub
  - QOZ business property (QOZBP)
- QOZBP = tangible property used in a trade or business if:
  - Acquired by purchase or lease after 12/31/17;
  - EITHER (a) original use in zone commences with QOF/QOZB; or (b) QOF/QOZB substantially improves it; and
  - During substantially all (90%) of holding period, substantially all (70%) use is in the zone
- Leasing property under triple-net lease does not constitute a trade or business



# QOF Structure



\*Assumes at least 90% of value of QOF's assets consist of QOZBs or QOZBP

# Business Activities and Operations

- Substantial Improvement Test (for QOZBP)
  - During any 30-month period beginning after acquisition, additions to basis = at least original basis (2x basis rule)
  - Basis of land excluded from test
- QOZB = a trade or business conducted by 1<sup>st</sup> tier sub:
  - substantially all (70%+) property of which is QOZBP,
  - 50% or more of gross income from conduct of business in OZ
  - Substantial portion (40%+) of intangible property used in active conduct of business
  - Less than 5% of property is nonqualified financial property, &
  - Not “sin” business (e.g., gambling, hot tubs, tanning, etc.)

# Qualified Opportunity Zone Business

- QOZ stock or QOZ partnership will qualify as QOZP if:
  - Stock/interest acquired (a) after 12/31/17, (b) at original issue, (c) solely for cash
  - Entity is a QOZB during substantially all (90%) of QOF's holding period
- 31-month safe harbor for unlimited working capital if QOZB acquires, constructs or rehabilitates tangible business property or develops a trade or business if:
  - QOZB has written plan in place identifying cash held for project,
  - Written schedule for deployment of the cash, and
  - QOZB substantially complies with the plan

# Leased QOZBP

- Leased property treated as QOZBP, for a QOF or a QOZB, if:
  - Lease is entered into after 12/31/2017
  - Lease is at market rate and contains arm's length terms
  - During substantially all holding period, substantially all use in OZ
- Related party leases permitted, if:
  - No prepayment allowed for periods > 12 months, and
  - For personal property, if lessee is not original user in the OZ, lessee must acquire other tangible property of equal or greater value within 30 months or lease term if shorter
- For improved real property, no plan exists when lease is entered to sell the property to lessee for other than FMV as of purchase date
- No "original use" or "substantial improvement" test for leased prop.
- Leasehold improvements satisfy original use test

# Misc. OZone Rules

- If QTP sells entire qualifying investment before 12/31/26, deferral may continue if new qualifying investment acquired within 180 days
- Sunset of QOZ designation on 12/31/2028 does not affect tax benefit of 10-year hold before 1/1/2048
- 31 Month Safe Harbor for Working Capital
  - Tolloed for delays for government approval
  - New 31-month period for additional contributions
- No substantial improvement requirement for unimproved land, but:
  - Must be used in a trade or business, and
  - QOF/QOZB must intend to make improvements w/i 30 months
- Original use test satisfied for:
  - Building vacant for 5 or more years
  - New construction not yet placed in service

# Misc. OZone Rules Continued

- Used tangible personal property can be “original use” if QOF is first user in that QOZ
- QOZ benefits inapplicable to carried (profits) interests
- 3 Safe harbors for 50% gross income test
  - At least **50% (by hours)** of services performed by service providers occur in the QOZ
  - At least **50% (by compensation)** of services performed by service providers occur in the QOZ
  - **Tangible property + management or operational functions** in QOZ are each necessary for generation of 50% of gross income

# Example: Safe Harbor 1 & 2

- SH 1 & 2: Tech start-up located in a QOZ develops software for sale through internet download. The majority of total service provider hours are by developers working in the QOZ.
- If the business also operates a service center outside the QOZ, it may still qualify even if the majority of service provider hours occur at the service center, as long as the total compensation for services performed within the QOZ is at least 50% of total aggregate compensation

# Example: Safe Harbor 3

A landscaping business has both its headquarters and its management function in a QOZ. The employees and managers that are located in the QOZ manage the activities of the business, whether they take place within or outside of a QOZ. The equipment and supplies are stored at the HQ facility. Third safe harbor met because tangible property is located in a QOZ (equipment and supplies) and management occurs within a QOZ



# Interim Gains

- If QOF sells QOZP and reinvests proceeds within 12 months in other QOZP, reinvested proceeds satisfy 90% test
  - Until reinvested, proceeds must be held in cash, cash equivalents or debt instruments with term of 18 months or less
  - 12-month period tolled for governmental delays
- Interim gains are not excluded from income
- In the case of a QOF partnership or S corp., investors who have held their interests for 10 years or more may elect to exclude capital gain (but not ordinary income) from QOF sale of QOZP
  - Unlike most other provisions of the proposed regs., this rule can't be relied on until finalized
  - This rule does not apply to gain passed through QOZB from the sale of its QOZBP

# Estate Planning Applications

- Owner of qualifying investment dying before 12/31/2026:
  - Devisee/revocable trust beneficiary treats the deferred income as income in respect of a decedent under IRC §691
  - Income inclusion will likely result in phantom gain—cash to pay the tax will have to come from somewhere else
  - In the case of a closely-held QOF partnership, consider a debt-financed distribution if the QOF interest has been held for at least two years
- Holding period tacks for transfers of qualifying investments that are not inclusion events
  - Transfers at death
  - Transfers to grantor trusts or other DREs

# Estate Planning Applications (2)

- Traditional estate “freeze” techniques are income tax inefficient because of loss of stepped-up basis at death of donor
  - Completed gift of a qualifying investment to a grantor trust should move appreciation out of the estate and result in a stepped-up tax basis
  - After deferral period, donor will pay the income tax from funds otherwise includible in her estate, reducing her taxable estate without gift tax consequences
- Leveraging gifts of qualifying investments with valuation discounts should be permissible
- Traditional freeze planning with QOF partnerships should be permissible because proposed regs. permit special allocations and preferred interests, but IRC §§ 2036 and 2701 must be satisfied

# Estate Planning Applications (3)

- Gifts of qualifying investments to GRATs should be permissible
  - Remainder beneficiary of GRAT should be a grantor trust instead of individuals or a nongrantor trust.
- Income tax rates might be higher after the deferral period
- Contributions to grantor trusts are not inclusion events, but distributions from such trusts may be
- At least two commentators think creating a partnership (QOF) for the purpose of investing in economically distressed areas in furtherance of Congressionally approved public policy constitutes a legitimate and significant non-tax business purpose that should satisfy the “bona fide sale” exception to IRC §2036
- You can't put lipstick on a pig!

# Estate Planning Example

TP sells appreciated stock with a zero basis for \$10M in 2019 and makes a qualifying investment in a QOF for that amount. TP then makes a completed gift of the qualifying investment to a GST-exempt dynasty trust that is a grantor trust for income tax purposes. After five years, the basis in the qualifying investment is increased to \$1M. After seven years, it is increased to \$1.5M. In 2026 (actually April 15 of 2027), tax on 85% of the deferred capital gain (assuming that amount is less than the FMV of the qualifying investment, less the adjusted basis) will be paid from TP's assets outside of the trust. The trust sells the qualifying investment for \$30M after holding it for 10 years and makes the election to step up its basis in the investment to FMV. The \$20M of appreciation will escape income taxation and the value of the \$30M proceeds will be excluded from TP's estate.

# Helpful Resources

- Todd Angkatavanich, Esq. and David Herzig, Esq., Frozen Ozone (Fr-Ozone) Planning—The Newest Flavored Estate Freeze, Estate Gifts & Trusts Journal (BNA), July 11, 2019
- Lisa M. Starczewski, Esq., The Eagerly Awaited Opportunity Zone Regulations: What Do They Tell Us and What Do We Still Need to Figure Out?, Real Estate Journal (BNA), November 07, 2018
- Lisa M. Starczewski, Esq., The Second Set of Proposed Opportunity Zone Regulations: Where Are We Now?, Real Estate Journal (BNA), May 01, 2019