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Proposed Amendments to the Opportunity Zone Statute

A&S Opportunity Zone Practice Group
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A bipartisan and bicameral (yes, you heard that correctly) bill has been introduced in Congress to reform and improve the Opportunity Zone program (the "OZ Program"). The Opportunity Zones Transparency, Extension, and Improvement Act (the "Bill") would enact a number of statutory changes to the OZ Program, and overall the Bill has more carrots than sticks, so it is welcome news in the Land of OZ.

The Bill has a number of hurdles to clear before becoming law, and its passage is uncertain at this point despite its bipartisan support. Two of the big ticket changes include the early sunset of certain high income Opportunity Zones and the extension (and revival) of certain tax incentives. These are discussed below, along with a summary of the other proposed changes.

Early Sunset of Non-Impoverished Opportunity Zones and Creating New Opportunity Zones

Because the original designation of Opportunity Zones was based on census data that was almost 10-years old (the 2018 designation process used data from the 2010 census), some census tracts that were designated as Opportunity Zones were viewed by many as not within the spirit of the OZ Program, despite meeting the technical qualifications. This concern has fueled a fair amount of criticism, since investors in those Opportunity Zones are receiving the OZ Program tax incentives for investing in areas that were seen as not particularly impoverished. Therefore, the Bill would sunset a small percentage of Opportunity Zone designations for tracts with a median family income at or above 130 percent of the national median family income, with certain exceptions. However, states would be able to designate a new tract in high-need communities for every tract that loses its designation.

The timelines in the Bill will be important to keep in mind if the Bill passes, since certain projects and businesses in the disqualified Opportunity Zones can be grandfathered in. The Treasury Department will have to publish an initial list of disqualified Opportunity Zones within a year of the enactment of the Bill, and the list must be finalized within 105 days of the publication of the initial list. The disqualified census tracts would lose Opportunity Zone status 30 days after the final list is published.

Certain existing investments in disqualified Opportunity Zone tracts could continue to operate as if the Opportunity Zone designation were still effective as long as the investment is a qualified pre-existing trade or business. A trade or business of a QOF or QOZB is a qualified pre-existing trade or business if (i) before the Bill is passed, the business files a registration statement with the SEC, prepares an offering memorandum, or prepares a similar disclosure document that discloses the intent of the business to invest in the disqualified census tract; (ii) before the disqualified census tract is included either on the initial or final list published by the Treasury Department, the business enters into a binding agreement to make an investment of more than $250,000 in the tract; or (iii) the Secretary of the Treasury determines that the business relied on the census tract's Opportunity Zone designation and will suffer a loss as a result of its disqualification. This is intended to protect early-stage projects or businesses that relied on the original Opportunity Zone designation, which is important for start-up businesses or significant real estate development projects that might take months (or years) to complete. However, QOFs and QOZBs may not undertake new projects or enter into new trade or businesses in any disqualified tracts.

Extension of Deferral Period

The Bill extends the end of the gain deferral period from December 31, 2026 to December 31, 2028. This would provide an additional 2-year period to defer gain recognition. The rationale of the Bill's sponsors is that it took the Treasury Department nearly two years to issue final regulations on Opportunity Zones, so they propose to extend the policy by an equal amount of time, which is especially important with the economy in recovery from the impact of COVID-19.

Notably, the proposed legislation does *not* extend the window for investors to invest into 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. It is not clear if this was an oversight, but as drafted the 2-year extension applies only to the deferral period.

The Bill would also revive both of the previously expired basis step-up incentives for investors. Under the 5-year benefit, investors get a 10% basis step-up (which means a complete elimination of 10% of the initial deferred gain) if they are invested in a QOF for at least 5 years prior to the end of the deferral period. Under the original legislation, investors needed to be invested in a QOF by December 31, 2021 to be eligible for the 5-year benefit. If the extended deferral period is December 31, 2028, investors would be eligible for the 5-year basis step-up as long as they are invested in a QOF by December 31, 2023.

Another carrot in the Bill is the modification of the prior 7-year benefit, which provided investors with an additional 5% basis step-up (for a total of 15%, so a complete elimination of 15% of the initial deferred gain) if they invested in a QOF at least 7 years prior to the end of the deferral period. Under the original legislation, investors needed to be invested in a QOF by December 31, 2019 to be eligible for the 7-year benefit. The Bill would change the 7-year benefit to a 6-year benefit, so with an extended deferral period until December 31, 2028, investors would be eligible for the 15% basis step-up if they are invested in a QOF by December 31, 2022.

These changes would apply to both existing and new QOF investors. There would be no change to the benefit that excludes from tax gains on QOF investments held for 10 years.

Other Notable Changes

- **Reinstate and expand reporting requirements**: The Bill would reinstate reporting requirements that were taken out in the 2017 tax reform process, and expand on those requirements. Those of us in the Land of OZ have been asking for a robust reporting mechanism since the initial passage of the OZ Program, since more data will promote transparency, ensure the OZ Program is operating as intended, and allow for the tracking of long-term outcomes in designated communities.

- **Penalties for noncompliance**: A new penalty regime would apply to QOFs, QOZBs and investors who fail to comply with the new suite of reporting requirements.

- **Fund-of-fund investments**: The Bill would allow QOFs to be organized as a "fund of funds" that invest in other QOFs.

- **Brownfields areas**: Under the Bill, certain unpopulated industrial brownfields sites could be designated as Opportunity Zones.

What Happens Next?

It is too soon to say how likely this Bill is to become law. We are in a midterm election year, President Biden is trying to revive his domestic agenda before the calendar gets too close to November, and despite the bipartisan sponsorship of the Bill, the OZ Program still has some vocal opponents.

The Magic 8-Ball has a few possibilities though.

- "**Outlook good**" – If President Biden is able to push through even part of his recently re-released policy proposals, the Bill could get tacked onto another piece of legislation and end up on his desk for signature.

- "**Don't count on it**" – Even if some legislation does work its way through Congress in the next few months, there are a lot of eyes on the current legislative proposals and we would expect a more robust review of the Bill than the original legislation for the OZ Program (which was included in the very rushed Tax Reform process at the end of 2017).

- "**Reply hazy, try again**" – Remember that the original OZ Program legislation was also drafted and sponsored with bipartisan support, so it has the ability to be a unifying program across the aisle. We may see a pullback of some carrots in the Bill if it can get that far, and the proposed reporting requirements should help to address a longstanding concern.

The A&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

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