

OBBBA- Qualified Opportunity Zones

Take-Away: The One Big Beautiful Bill Act provides a new set of favorable rules for Qualified Opportunity Zone Investments, starting in 2027. However, that also means that current Qualified Opportunity Zone investments will face a critical liquidity event at the end of 2026 when the gain deferral for those investments ends.

Caveat: What follows is a complicated (dare I say turgid?) explanation of the existing and future Opportunity Zone rules.

Background: The One Big Beautiful Bill (OB-3) created several changes to the 2017 Tax Act's Qualified Opportunity Zone (QOZ) investment rules. Those new rules will start on January 1, **2027**, which follows the 'close' of the 2017 Tax Act's QOZ rules which end on December 31, 2026. A key point is that the first QOZ *tranche* of investments ends on that date, **when any deferred capital gains with those QOZ investments will be deemed recognized.**

Day of Reckoning: Some have called the December 31, 2026, date a 'Day of Reckoning' which triggers a deemed disposition of the deferred gain recognition. Consequently, owners of these *first-tranche* QOZ investments should start to plan now for their liquidity to deal with income tax deferral.

2017 Tax Act- Opportunity Zones and Funds: The 2017 Tax Act created a couple of new concepts.

Qualified Opportunity Zone: An opportunity zone (QOZ) is defined as an economically distressed community where investment might be eligible for preferential tax treatment. OZs are nominated for this designation by the state, and the designation is then certified by the IRS.

Qualified Opportunity Fund: A qualified opportunity fund (QOF) is an investment vehicle that is established either as a domestic partnership or a domestic corporation. It *cannot* be a single member LLC. Its purpose is to invest in eligible property that is located in an OZ

and uses investor gains from prior investments as a funding mechanism. A QOF self-certifies, and it must meet certain requirements, one being that at least 90% of its assets must be 'QOZ property' that is used within the OZ. However, no IRS action is required to form a QOF. The self-certification is on IRS Form 8996, and which Form must be timely filed with the entity's federal income tax return for the taxable year, including tax filing extensions.

IRD- Death of QOZ Investor: In the case of a deceased QOZ investor, the amounts recognized will, if not properly included in gross income of the decedent, be included in the gross income as provided in IRC 691, i.e., income in respect of a decedent (IRD.) [IRC 14002-2(e)(3).] In other words, there is no step-up in income tax basis for QOZ investments. An inherited IRD asset under IRC 1014(c) means inheriting a built-in income tax liability. This tax liability will also come due on the Day of Reckoning, or December 31, 2026.

Gain Not to Exceed FMV: A special rule limits the fair market value of the QOZ investment at the date of this 'trigger' event. This special rule limits the amount of the gain so as to not exceed the fair market value (FMV) of the investment as of the date the gain is included in income.

Example: Assume that the deferred OZF investment is \$20 million, ignoring any basis adjustment provided under the 2017 Tax Act. If the QOF investment has gone down in value over the years to \$5 million, this rule says that the lesser of the two amounts limits the gain prior to the basis adjustment at only \$5 million.

No Valuation Discounts: The 2017 Tax Act also provides that no valuation discounts for lack of control and lack of marketability can be used for purposes of determining a QOF investment's fair market value.

Gifts-Deemed Sales: Gifts are treated under the 2017 Tax Act as dispositions of the QOZ investment, thus triggering inclusion of deferred gain and income. In short, a gift of a QOZ investment is treated as a 'deemed sale', if it is in the form of a direct gift of the QOZ investment to the donee.

However, if the gift is to an irrevocable trust, it is not treated as a 'deemed sale' or disposition of the QOZ investment and thus it does not trigger inclusion of the deferred gain in income. This includes a transfer of the QOZ investment to a grantor trust, e.g., a sale to an IDGT or a 'swap' of assets with the *grantor* trust.

2017 Tax Act QOZ Benefits: The initial QOZ investments that were created under the 2017 Tax Act [IRC 1400Z-2] were intended to incent investments with three projected benefits.

Deferral of Gain: There is a deferral of gain on the disposition to unrelated persons of a QOZ investment until the earlier of the date on which the QOZ investment is sold or exchanged, or January 31, 2026, so long as that gain is reinvested in a QOZ investment within 180 days, or 180 'deemed' days of the property's disposition. No interest is charged on this deferral of gain. This rule, as noted earlier, thus creates the Day of Reckoning on December 31, 2006.

Elimination of 15% of Gain: IRC 1400Z-2 eliminates up to 15% of the gain that is reinvested in a qualified opportunity fund (QOF), so long as a specified holding period under the statute is satisfied.

Ten-year Holding- Elimination of Tax: The 2017 Tax Act also provides for the elimination of tax on gains associated with the appreciation in value of a QOF investment if the QOF investment was held for at least 10 years.

One Big Beautiful Bill Act Provisions: OB-3, as noted above, creates a second *tranche* of QOZ investments and funds, subject to a new set of rules. Some of the major QOZ investment changes under OB-3 are:

No New Day of Reckoning: The QOZ program is extended indefinitely.

Second *Tranche* 'Start' Date: The second *tranche* of QOZ investments starts on January 1, 2027.

New QOZs: Every ten (10) years a state governor will propose new QOZs, that the IRS will then certify, with the effective date for that new QOZ designation to be July 1, 2026, and every ten years thereafter.

‘Contiguous Rule’ Dropped: There will be tighter eligibility criteria applied to QOZ designations going forward. OB-3 repeals the prior ‘contiguous rule’ which allowed a census tract contiguous to a low-income community to be designated as a QOZ, so long as its median family income did not exceed 125% of median family income, i.e., the low-income community to which the tract was adjacent.

5% Basis Increase Eliminated: The Act eliminates the 2017 Tax Act’s 5% basis step-up which applied to a the 7-year QOF investment holding period, and it limits that benefit to 10%.

5-Year Rolling Deferral: A new 5-year rolling gain deferral rule and a permanent 10% basis step-up are part of the new QOZ rules. The 10% basis step-up is also part of the new rules. Accordingly, for QOZ investments made after December 31, 2026, gains deferred through investments in the QOZ program will now be recognized on the 5th investment anniversary date, unless there is an earlier sale or exchange, including a ‘deemed sale or exchange’ rather than on the fixed date. The new Act also makes permanent the 10% basis step-up which takes effect immediately before the end of the 5-year deferral period. This means that after December 31, 2026, all gains that are not prematurely triggered, such as through a sale or exchange or ‘deemed sale or exchange’ of an investment in a QOF will enjoy the benefit of a 10% basis increase after 5 years.

Qualified Rural Opportunity Fund: OB-3 Also creates a new concept called a Qualified Rural Opportunity Fund (QROF) that provides enhanced benefits to this ‘new’ investment. A QROF is a QOF which uses a 90% asset test, including respect to any QOZ business in which a QOF owns an interest, comprised entirely of rural area property. Rural area property is defined in the Act as any area *other than* either (i) a city or town where there is a population greater than 50,000 or (ii) an urbanized area adjacent to a city or town that has a population nexus of 50,000. The enhanced tax benefits associated with a QROF investment are: (a) the investor receives a 30% basis step-up after 5 years (compared to the 10% step-

up in basis for a 'regular' QOF investment; and (b) There is a 'relaxation' of the 'substantial improvement' requirement for other QOF investments, basically the 100% 'test' to double basis over the prescribed period is reduced to 50%.

30-Year Rule: There will be a QOZ gain elimination frozen after 30 years, since the QB-3 eliminates the sunset provisions that terminate QOZ benefits or QOF investments liquidated after December 31, 2047. Instead, OB-3 establishes in its place a 30-year rolling horizon and gain elimination respect to post-10-year dispositions of QOZ investments. For investments sold or exchanged before 30 years, a step-up in basis will reflect the fair market value of the investment as of the date such investment is sold or exchanged. In contrast, for QOZ investments held 30 years or more, the basis step-up will be frozen at the fair market value on the 30th anniversary of that 'new' QOZ investment.

Conclusion: The QOZ rules that implicate estate planning are generally unchanged by the OB-3. All of the new rules become effective after December 31, 2026. However, that date is important since it marks the end of the original QOZ *tranche* of investments and their deferral of gain recognition, i.e., the day when the deferred gain in these original investments must be recognized- the Day of Reckoning. Consequently, investors in the original *tranche* QOFs need to plan for their liquidity needs to fund the capital gains tax liability that they will face next year due as a result of the deemed gain recognition on that date.

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