UBS

Qualified opportunity funds

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Since 2018, federal tax laws have offered meaningful incentives for investing in qualified opportunity funds. These incentives were designed to encourage investment in qualified opportunity zones, which are certain designated low-income communities.[1] By investing in a qualified opportunity fund, a person who has realized capital gains potentially can defer the recognition of those gains (albeit not indefinitely), avoid tax on a portion of those gains (if they invested before 2022 and hold the investment for the requisite time), and avoid tax on post-investment gains (if they hold the investment for ten or more years).[2] A web of rules govern the deferral, forgiveness, and recognition of gains in connection with an investment in a qualified opportunity fund.

Qualified opportunity fund

A qualified opportunity fund is an entity that's organized for the purpose of investing in qualified opportunity zone property (other than other qualified opportunity funds).[3] In fact, 90% or more of its assets must be qualified opportunity zone property.[4] Qualified opportunity zone property generally is:

- any qualified opportunity zone stock, which is stock in a corporation that is a qualified opportunity zone business, is acquired by the fund after 2017, and is acquired at its original issue from the corporation in exchange solely for cash;[5]
- any qualified opportunity zone partnership interest, which is a capital interest or profits interest in a partnership that is a qualified opportunity zone business, is acquired by the fund after 2017, and is acquired from the partnership in exchange solely for cash;[6] and
- any qualified opportunity zone business property, which is tangible property that is used in a trade or business of the fund, is acquired by the fund acquired after 2017, and is first used in the qualified opportunity zone when the fund commences or when the fund substantially improves the property.[7]

A qualified opportunity zone business generally is a trade or business in which substantially all of its tangible property is acquired by the business after 2017 and is first used in the qualified opportunity zone when the business commences or when the business substantially improves the property.[8]

Deferral of capital gains

A person who realizes capital gains and invests in a qualified opportunity fund generally may elect to defer those gains.[9] The person generally must invest in the fund within 180 days after realizing the gains they are electing to defer.[10] The amount of deferred gains can't exceed the amount of the investment in the qualified opportunity fund.[11] A person can defer some but not all eligible gains or defer eligible gains, and a person can defer gains from one sale or exchange by investing in two or more qualified opportunity funds.[12]

Eligible gains

A person can defer eligible gains.[13] Eligible gains are short-term and long-term capital gains recognized before 2027.[14] They generally include:

- section 1231 gains,[15] which include gains from the sale of depreciable or real property that is used in a trade or business and has been held for more than one year;[16]

[1] IRC § 1400Z-1(a).
[2] As attractive as these tax incentives may be, investing in a qualified opportunity fund involves risk and ought to be viewed first and foremost as an investment decision.
[3] IRC § 1400Z-2(d)(1) and Treas. Reg. § 1.1400Z2(d)-1(a)(1)(i). A qualified opportunity fund must be classified as a corporation or partnership for federal income tax purposes, and it generally must be organized in the United States. Treas. Reg. § 1.1400Z2(d)-1(a)(1)(i) and (ii).
[4] Id.
[5] IRC §§ 1400Z-2(d)(2)(A)(i) and (B). See also Treas. Reg. §§ 1.1400Z2(d)-1(c)(1)(i) and (c)(2).
[6] IRC §§ 1400Z-2(d)(2)(A)(ii) and (C). See also Treas. Reg. §§ 1.1400Z2(d)-1(c)(1)(ii) and (c)(3).
[7] IRC §§ 1400Z-2(d)(2)(A)(iii) and (D). See also Treas. Reg. §§ 1.1400Z2(d)-1(c)(1)(iii) and 1.1400Z2(d)-2.
[8] IRC § 1400Z-2(d)(3). See also Treas. Reg. §§ 1.1400Z2(d)-1(d).
[9] IRC § 1400Z-2(a)(1)(A). The person must be an eligible taxpayer, but that generally encompasses anyone who must report the recognition of gains during the taxable year, including individuals, C corporations, and, subject to certain special rules, partnerships, S corporations, trusts, and decedents' estates. Treas. Reg. § 1.1400Z2(a)-1(b)(13). A comment on word usage. It may be more precise to say a person who realizes capital gains and invests in a qualified opportunity fund generally may elect to defer the *recognition* those gains. For simplicity, however, we'll often speak in terms of the person deferring gains.
[10] IRC § 1400Z-2(a)(1)(A). See also Treas. Reg. § 1.1400Z2(a)-1(b)(7).
[11] Treas. Reg. § 1.1400Z2(a)-1(c)(6)(i).
[12] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(ii).
[13] Id. See also Treas. Reg. § 1.1400Z2(a)-1(a)(1).
[14] Treas. Reg. §§ 1.1400Z2(a)-1(b)(11)(i)(A) and (B).
[15] Treas. Reg. §§ 1.1400Z2(a)-1(b)(11)(i)(A) and (11)(iii).
[16] IRC § 1231(a)(3)(A).

- gains realized under an installment sale (including a sale before 2018) to the extent the gains otherwise would qualify as eligible gains;[17] and
- gains realized upon a sale or transfer of an interest in a qualified opportunity fund.

A person who realizes gains and losses in the same year generally ignores the losses when determining their eligible gains.[19]

Some gains don't qualify as eligible gains. Eligible gains don't include gains that are characterized as ordinary income.[20] For example, they don't include section 1231 gains that are recharacterized as ordinary income under the depreciation recapture rules.[21] They also generally don't include gains from a section 1256 contract (which generally is a regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or dealer securities futures contract) or a straddle.[22]

Eligible gains also don't include gains from a sale or exchange with a related person.[23] In the case of an individual, related persons include:

- the individual's spouse;
- the individual's ancestors;
- the individual's siblings;
- the individual's descendants;
- any corporation of which the individual owns (by value) more than 50 percent of the outstanding stock;
- any partnership of which the individual owns more than 50 percent of the capital interest or more than 50 percent of the profits interest;
- any trust of which the individual is a settlor (i.e., a person who contributes property to the trust);
- any trust of which the individual is a beneficiary; and
- any private foundation or other tax-exempt charitable organization that the individual or the individual's family members control.[24]

For example, an individual who sells property to a sibling and consequently realizes capital gain can't defer the gain by investing in a qualified opportunity fund. In the case of a corporation, partnership, or trust, certain individuals and entities similarly are related persons.[25]

180-day period

A person who realizes eligible gains and wishes to defer those gains generally must invest in a qualified opportunity fund within 180 days after realizing those gains.[26] There are some special rules. For example, a partnership can defer eligible gains that it realizes to the extent it invests in a qualified opportunity fund within 180 days after realizing those gains.[27] By doing so, the partnership enables its partners to enjoy the benefits of the deferral. If, however, the partnership doesn't invest in a qualified opportunity fund within 180 days after realizing those gains (or, despite making a qualifying investment in that 180-day period, it doesn't elect to defer those gains), then each partner can defer their allocable share of the eligible gains to the extent they invest in a qualified opportunity fund within 180 days after the end of the partnership's taxable year.[28] Thus, for eligible gains that a partnership doesn't defer, a partner's 180-day period begins when the partnership's taxable year ends rather than when the partnership realized those gains. Similar rules apply to S corporations, nongrantor trusts, and estates.[29]

[17] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(viii)(A).
[18] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iv).
[19] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A)(1).
[20] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(A)(2).
[21] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(iii)(A).
[22] Treas. Reg. § 1.1400Z2(a)-1(b)(11)(vi)(A)(1) and (2). See IRC § 1256(b). Gain from a qualified section 1256 contract (which is a section 1256 contract that isn't a part of a straddle at any time during the taxable year) or an identified straddle, however, potentially is eligible gain. Treas. Reg. § 1.1400Z2(a)-1(b)(11)(vi)(B) and (C).
[23] IRC § 1400Z-2(a)(1). See also Treas. Reg. § 1.1400Z2(a)-1(b)(11)(i)(C).
[24] Treas. Reg. § 1.1400Z2(a)-1(b)(39). See IRC §§ 267(b) and 707(b)(1).
[25] Id.
[26] IRC § 1400Z-2(a)(1)(A). See also Treas. Reg. § 1.1400Z2(a)-1(d)(1). Due to the COVID-19 pandemic, the Internal Revenue Service (IRS) extended the 180-day period. For a person whose 180-day period would have ended on or after April 1, 2020, and before March 31, 2021, the IRS automatically extended the time to invest the eligible gains to March 31, 2021. Notice 2021-10.
[27] Treas. Reg. § 1.1400Z2(a)-1(c)(7).
[28] Treas. Reg. § 1.1400Z2(a)-1(c)(8).
[29] Treas. Reg. § 1.1400Z2(a)-1(c)(9). A nongrantor trust is a trust that, for federal income tax purposes, is treated as a separate taxpayer.

Election
A person who invests in a qualified opportunity fund and wishes to defer eligible gains must elect to defer those gains.[30] The person makes the election on their federal income tax return (specifically, Form 8949) for the year in which the gains would be includible in the person's gross income if wasn't deferred.[31] In addition to making the election on Form 8949, the person must report the investment in the qualified opportunity fund on Form 8997.

End of deferral
The deferral from investing in a qualified opportunity fund is not indefinite. When the deferral ends, the deferred gains are realized (and thus potentially taxable). The deferral ends on the earlier of:

- an inclusion event (e.g., a sale, exchange, or, in certain cases, transfer of an interest in the qualified opportunity fund); [32] and
- December 31, 2026.[33]

We discuss the recognition of deferred gains below.

Partial forgiveness of gain for investments held five or more years

For a person who holds a qualifying investment (which generally is an interest a qualified opportunity fund to the extent an election to defer eligible gains has been properly made) for five or more years, 10% of the deferred gain is forgiven. More specifically, once the person has held the qualifying investment for five years, there's a basis adjustment; the person's basis in the investment generally is increased by an amount equal to 10% of the deferred gain.[34] Since all remaining deferred gains will be recognized on December 31, 2026, this partial forgiveness benefits only persons who invested in a qualified opportunity fund on or before December 31, 2021. A person who invested on January 1, 2022, or later will not have held the investment for five or more years when the gains are recognized on December 31, 2026.

Partial forgiveness of gain for investments held seven or more years

For a person who holds a qualifying investment for seven or more years, an additional 5% of the deferred gain is forgiven. More specifically, once the person has held the qualifying investment for seven years, there's another basis adjustment; the person's basis in the investment generally is increased by an amount equal to 5% of the deferred gain.[35] Thus, for a person who holds an investment in a qualified opportunity fund for seven of more years, a total of 15% of the deferred gain is forgiven. Since all remaining deferred gains will be recognized on December 31, 2026, this partial forgiveness benefits only persons who invested in a qualified opportunity fund on or before December 31, 2019. A person who invested on January 1, 2020, or later will not have held the investment for seven or more years when the gains are recognized on December 31, 2026.

Forgiveness of post-investment gains for investments held ten or more years

A person who holds a qualifying investment for ten or more years can elect to exclude from income certain gains and losses allocable to them from the qualified opportunity fund if the qualified opportunity fund is a partnership or S corporation.[36] Gains and losses are excludible to the extent that they arise from the sale or exchange of property by the qualified opportunity fund or a partnership that it owns (either directly or through one or more other partnerships).[37]

In addition, a person who holds a qualifying investment for ten or more years can elect to have the gain on the investment forgiven (regardless of whether the qualified opportunity fund is a partnership or S corporation). More specifically, upon the sale or exchange of a qualifying investment held ten or more years, the person generally can elect to adjust their basis in the investment so that it equals the investment's fair market value upon its sale or

[30] IRC § 1400Z-2(a)(1)(A).
[31] Treas. Reg. § 1.1400Z2(a)-1(a)(2).
[32] Treas. Reg. § 1.1400Z2(b)-1(b)(1).
[33] Treas. Reg. § 1.1400Z2(b)-1(b)(2).
[34] IRC § 1400Z-2(b)(2)(B)(iii). See Treas. Reg. §§ 1.1400Z2(a)-1(b)(34) and 1.1400Z2(b)-1(g)(2). A person's holding period generally begins when the person makes the investment in the qualified opportunity fund. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(i).
[35] IRC § 1400Z-2(b)(2)(B)(iv). See Treas. Reg. § 1.1400Z2(b)-1(g)(2). A person's holding period generally begins when the person makes the investment in the qualified opportunity fund. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(i).
[36] Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii). A person's holding period generally begins when the person makes the investment in the qualified opportunity fund. Treas. Reg. § 1.1400Z2(b)-1(d)(1)(i). The sale or exchange of property by the qualified opportunity fund must occur before 2048. Treas. Reg. § 1.1400Z2(c)-1(c).
[37] Id.

exchange.[38] By doing so, the post-investment gains become non-taxable. The person would have recognized the deferred gains no later than December 31, 2026. Thus, this election only affects post-investment gains.

This election generally won't make economic sense for a person who would realize a loss upon the sale or disposition of the investment. If a person who has held a qualifying investment for ten or more years would realize a loss upon a sale or exchange of the investment, making the election would eliminate the loss. Accordingly, the person ordinarily would forgo the election so they could realize the loss.

Realization of deferred gains

The deferral from investing in a qualified opportunity fund is not indefinite. A person recognizes deferred gains on the earlier of:

- an inclusion event; and
- December 31, 2026.[39]

An inclusion event generally occurs upon:

- a sale, exchange, or (in certain cases) transfer of a qualifying investment;[40]
- a distribution of property from the qualified opportunity fund;[41]
- a claim for a deduction based on the interest having become worthless;[42] and
- the fund ceasing to qualify as a qualified opportunity fund.[43]

When there's an inclusion event, the person who holds the qualifying investment generally realizes the deferred gain.[44] A person who realizes gains upon an inclusion event and subsequently invests in a qualified opportunity fund generally may elect to defer those gains.[45] A person who holds a qualifying investment until December 31, 2026, recognizes the remaining deferred gains.[46] If, however, the interest's fair market value on December 31, 2026, exceeds the remaining deferred gains, the person recognizes gain in an amount equal to the interest's fair market value.[47] To the extent the person has any basis in the investment, the basis generally reduces the recognized gains.[48]

When a person recognizes deferred gain, the recognized gain has the same attributes as it would have had if it hadn't been deferred.[49] Let's say a person had deferred short-term capital gains when investing in a qualified opportunity fund. When the deferral ends, the person's recognized gain will be treated as short-term capital gain.[50] The tax rate on the recognized gain will be the tax rate in effect when the gain is recognized (e.g., in the case of an investment held until December 31, 2026, the capital gains and net investment tax rates in effect on that day). The person's basis in the investment will increase to include the amount of recognized gain.[51] A person who has a qualifying investment and plans to hold the investment beyond 2026 should make plans to have sufficient liquidity to be able to pay the taxes on the gains that will be recognized in 2026.

Estate planning considerations

For individuals, trusts, and other persons holding qualifying investments, the broad range of transactions that are inclusion events—and thus potentially trigger tax on deferred gains—has implications for many estate planning strategies.

[38] IRC § 1400Z-2(b)(2)(B)(iv) and Treas. Reg. § 1.1400Z2(c)-1(b)(1)(i). The sale or exchange must occur before 2048. Treas. Reg. § 1.1400Z2(c)-1(c).
[39] Treas. Reg. § 1.1400Z2(b)-1(b).
[40] Treas. Reg. § 1.1400Z2(b)-1(c)(1)(i). More precisely, any event that, for income tax purposes, reduces a person's direct equity interest in a qualified opportunity fund generally is an inclusion event.
[41] Treas. Reg. § 1.1400Z2(b)-1(c)(1)(ii). The distribution must be treated as a distribution for income tax purposes.
[42] Treas. Reg. § 1.1400Z2(b)-1(c)(1)(iii).
[43] Treas. Reg. § 1.1400Z2(b)-1(c)(1)(iii).
[44] Treas. Reg. § 1.1400Z2(b)-1(b).
[45] IRC § 1400Z-2(a)(1)(A).
[46] Treas. Reg. § 1.1400Z2(b)-1(e)(3)(i)(A).
[47] Treas. Reg. § 1.1400Z2(b)-1(e)(3)(i)(B).
[48] Treas. Reg. § 1.1400Z2(b)-1(e)(3)(ii).
[49] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(i).
[50] Treas. Reg. § 1.1400Z2(a)-1(c)(4)(i).
[51] Treas. Reg. § 1.1400Z2(b)-1(g)(1)(i).

Gifts, sales, and other transfers to a spouse

Although a transfer between spouses generally is non-taxable for income tax purposes,[52] a transfer of a qualifying investment from an individual to the individual's spouse is an inclusion event.[53] This includes any transfer by gift, sale, or incident to divorce.[54] Consequently, an individual will recognize the deferred gains upon a gift of a qualifying investment to their spouse. In contrast, a gift to a trust of which the spouse is a beneficiary won't trigger recognition of the deferred gains so long as the trust is a grantor trust with respect to the individual making the gift.[55]

Gifts to persons other than a spouse

A gift of a qualifying investment generally is an inclusion event.[56] For this purpose, a gift is a transfer that's a gift for gift tax purposes (whether in trust or otherwise).[57] It includes an incomplete gift,[58] which generally is a transfer in which the transferor retains the power to change the disposition.[59] A gift by the settlor of a grantor trust to the trust, however, is not an inclusion event.[60]

Gifts to charitable organizations

A gift of a qualifying investment to a tax-exempt charitable organization is an inclusion event.[61] Consequently, the donor will recognize the deferred gains when contributing a qualifying investment to a charitable organization.

Transfers to grantor trusts

The settlor of a grantor trust can transfer a qualifying investment to the trust without accelerating the recognition of the deferred gain. A grantor trust is generally disregarded for income tax purposes, and the settlor reports the trust's income, deductions, and credits on their personal income tax return.[62] A revocable trust is a grantor trust,[63] and many types of irrevocable trusts are too.[64]

A transfer of a qualifying investment to a grantor trust is not an inclusion event so long as the trust is a grantor trust with respect to the transferor.[65] The transfer may be a gift or sale.[66] In the case of a sale, the transaction must be a nonrecognition event for income tax purposes, but any sale between the settlor of a grantor trust and the trust ordinarily is a nonrecognition event.[67] Accordingly, the settlor of a grantor trust can sell a qualifying investment to the trust in exchange for a promissory note (which is a common strategy for shifting future appreciation out of the settlor's estate for estate tax purposes) without recognizing the deferred gain.[68] When a settlor of a grantor trust transfers a qualifying investment to the trust and the transfer isn't an inclusion event, the holding period for that interest includes the settlor's holding period before the transfer.[69]

Changes in a trust's income tax status

To the extent a trust holds a qualifying investment, a change in a trust's income tax status generally is an inclusion event, thus causing the deferred gains to be recognized.[70] For example, changing from a grantor trust to a nongrantor trust generally is an inclusion event. Likewise, changing from a nongrantor trust to a grantor trust also generally is an inclusion event.

[52] IRC §§ 1041(a) and (c).
[53] Treas. Reg. § 1.1400Z2(b)-1(c)(3)(ii).
[54] Id.
[55] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i).
[56] Treas. Reg. § 1.1400Z2(b)-1(c)(3)(i).
[57] Id.
[58] Id.
[59] Treas. Reg. § 25.2511-2(b).
[60] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i).
[61] Treas. Reg. § 1.1400Z2(b)-1(c)(3)(i).
[62] IRC §§ 671 to 679. In some cases, a trust can be a grantor trust with respect to a beneficiary of the trust. IRC § 678. In such a trust, the beneficiary reports the trust's income, deductions, and credits on their personal income tax return. For simplicity, this whitepaper focuses on trusts that are grantor trusts with respect to the settlor of the trust.
[63] IRC §§ 676(a). For purposes of this whitepaper, a revocable trust is a trust in which the settlor has the power to revest (i.e., take back) the property in the trust.
[64] For a discussion of these trusts, see Casey C. Verst, *Using Irrevocable Grantor Trusts to Transfer Wealth* (a publication of the UBS Advanced Planning Group).
[65] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i).
[66] Id.
[67] Rev. Rul. 85-13.
[68] For a more in-depth discussion of this strategy, see Casey C. Verst, *Sales to Grantor Trusts* (a publication of the UBS Advanced Planning Group).
[69] Treas. Reg. § 1.1400Z2(b)-1(d)(1)(iii).

There are exceptions. One exception applies when the settlor dies. A change of status by reason of the settlor's death is not an inclusion event.[71] When the settlor of a grantor trust dies, the trust ceases to be a grantor trust with respect to the settlor and typically becomes a nongrantor trust.[72] This isn't an inclusion event, so the deferred gains aren't recognized. Another exception applies to certain trusts that own shares of an S corporation. A change of status by reason of an electing small business trust (ESBT) converting to a qualified subchapter S trust (QSST) is not an inclusion event so long as the beneficiary of the QSST was the deemed owner of the grantor trust portion of the ESBT.[73] Since this conversion isn't an inclusion event, the deferred gains aren't recognized.

For tax planning reasons, the settlor of a grantor trust sometimes seeks to toggle off grantor trust status, so that the trust becomes a nongrantor trust and the settlor will no longer report the trust's income, deductions, and credits on their personal income tax return. If the trust held an interest in a qualified opportunity fund, this would be an inclusion event, triggering recognition of any deferred gains. If the settlor of a grantor trust wishes to toggle off grantor trust status, the trust holds a qualifying investment, and the settlor doesn't want to accelerate the recognition of the deferred gains, the settlor might consider acquiring the interest before toggling off grantor trust status. Under the terms of the trust, the settlor may have a substitution power, enabling the settlor to exchange the qualifying investment for property of equivalent value. Alternatively, the settlor potentially could buy the qualifying investment from the trust. In either case, the transaction wouldn't be an inclusion event, and the subsequent toggling off of the trust's grantor trust status wouldn't be an inclusion event.

Transfers by reason of death

A transfer of a qualifying investment by reason of an individual's death is not an inclusion event.[74] A transfer by reason of death includes:

– a transfer by reason of death to the deceased owner's estate;[75]
– a distribution of a qualifying investment from the deceased owner's estate to a beneficiary of the deceased owner's estate;[76]
– a distribution of a qualifying investment from the deceased owner's trust to a beneficiary of the trust so long as the distribution is made by reason of the deceased owner's death;[77]
– in the case of a qualifying investment owned jointly by the deceased owner and another individual, the passing of the qualifying investment to the surviving owner by operation of law;[78] and
– any other transfer of a qualifying investment at death by operation of law.[79]

A transfer by reason of death isn't an inclusion event, so there isn't any recognition of the deferred gains. In addition, the holding period for the person who acquires the qualifying investment includes the deceased owner's holding period.[80]

A qualifying investment doesn't get stepped-up basis if there is a transfer by reason of death.[81] The deferred gain is income in respect of a decedent and thus includible in the transferee's gross income when it's recognized (i.e., upon the earlier of an inclusion event or December 31, 2026).[82] Since the gain is income in respect of a decedent, the transferee potentially can claim an income tax deduction for the estate taxes attributable to the value of the qualifying investment to the extent the interest was includible in the deceased owner's estate.[83] The transferee

[70] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii).
[71] Id.
[72] In some cases, the trust might become partially or wholly a grantor trust with respect to one or more beneficiaries. IRC § 678.
[73] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii).
[74] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i).
[75] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)(A).
[76] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)(B).
[77] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)(C).
[78] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)(D).
[79] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)(E).
[80] Treas. Reg. § 1.1400Z2(b)-1(d)(1)(iii).

can claim this deduction in the year in which the deferred gains are recognized.[84]

A transfer occurring after an individual's death isn't necessarily a transfer by reason of death. Examples include:

– a sale, exchange, or other disposition by the deceased owner's estate or trust (other than a distribution from the estate or trust by reason of the deceased owner's death);[85]
– a disposition by the person who received the interest by reason of the deceased owner's death;[86] and
– a disposition by the surviving owner or other person who received the interest by operation of law on the deceased owner's death.[87]

In each case, the transfer is an inclusion event, so the deferred gains are recognized.

[81] IRC § 1014(c).
[82] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(iii).
[83] IRC § 691(c).
[84] Id.
[85] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(ii)(A).
[86] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(ii)(B).
[87] Treas. Reg. § 1.1400Z2(b)-1(c)(4)(ii)(C).

About the Advanced Planning Group

The Advanced Planning Group consists of former practicing estate planning and tax attorneys with extensive private practice experience and diverse areas of specialization, including estate planning strategies, income and transfer tax planning, family office structuring, business succession planning, charitable planning and family governance.

The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.

Disclosures

Certain considerations and risk factors of qualified opportunity zone funds

Neither UBS Financial Services Inc., its affiliates nor its employees provide tax or legal advice. Potential investors in Opportunity Zone Funds are urged to consult with their independent tax and legal advisors prior to making such an investment.

General risk factors of qualified opportunity zone funds

General Economic Risks of Investing in Opportunity Zones
Qualified opportunity zones are low income urban, suburban or rural communities that were nominated for that designation by each state and possession, and which were certified by the Secretary of the United States Treasury via delegation of authority to the Internal Revenue Service ("IRS"). The purpose of the legislation is to encourage economic growth and investment in these designated distressed communities by providing federal income tax benefits to taxpayers who invest within these zones. Investor members should understand that an investment in these distressed economic areas is subject to the risk that the anticipated economic growth may not materialize and could result in a loss of some or all of their investment.

Risks upon exit
Many funds with opportunity zone investments may be seeking an exit after 10 years so as to realize the tax benefits, as discussed further below. Sales into such a crowded market may be difficult or may yield less than expected returns.

Tax risks
An investment in a qualified opportunity fund ("QOF") potentially offers special tax benefits, but also involves risks that these benefits will not be available. Some of these risks are highlighted below. This summary only addresses tax issues specific to the treatment of a fund as a QOF and/or tax benefits under the Opportunity Zone ("OZ") rules, and does not address general tax issues for investment funds.

General tax risks
OZ rules are new. The US Department of the Treasury and the Internal Revenue Service have issued final regulations, but many questions remain unanswered.

Anticipated tax benefits may not be available. Failure to meet any of the qualification requirements discussed below may reduce or eliminate the OZ tax benefits. Some of these will generally be within the investor's control, such as investing qualifying capital gains within 180 days, but others—such as whether a fund maintains its qualification as a QOF—will not.

State and local tax treatment may differ. An investor may not receive OZ tax benefits for state tax purposes, because not all states will conform to the federal tax treatment. That means the investor may need to pay state taxes on capital gains that an investor defers for federal tax purposes by investing in QOF interests.

Tax risks of investing in a QOF
Eligible gains. To enjoy OZ tax benefits, an investor must invest Eligible Capital Gains in QOF interests. Eligible Capital Gains are gains from the sale of a capital asset, such as stock or real estate held for investment, other than gains arising from a position that is or has been part of a so-called "offsetting-positions transaction," but do not include capital gains that are re-characterized as ordinary income.

Investment within 180 days. To enjoy OZ tax benefits, aninvestor must invest in the QOF within 180 days of a taxable sale or exchange. Special rules apply to determine the 180-day period for the investor's share of Eligible Capital Gains recognized by a partnership or other entity in which the investor owns an interest. The QOF's closing, however, may not occur within the 180-day period following the investor's recognition of gain.

Deferral election. An investor may lose OZ benefits if the investor does not properly make a deferral election on IRS Form 8949, which must be attached to the investor's federal income tax return for the taxable year in which thegain would otherwise have been recognized.

Tax risks while holding the QOF investment
Loss of tax benefits if fund does not qualify as QOF. The OZ tax benefits are available when an investor invests in a QOF. If the fund loses this status—as discussed further below—the investor's tax benefits may be reduced or eliminated. The regulations make clear that the Ten-Year Benefit will be available through 2047 even if a census tract's designation as a qualified opportunity zone expires, but do not address other disqualification issues.

Fund terms may differ from typical investment fund. For example, OZ investments may be structured as separate entities, with no netting of carried interest, to facilitate exit after 10 years. This means that the sponsor may be compensated for gains in one QOF without any reduction for losses in another QOF.

Investment is otherwise taxable. The OZ rules primarily provide a tax deferral upon entry and a tax benefit upon exit; the normal tax rules generally apply to a fund's operations. As with many investment funds, an investor may need to pay tax on the investor's share of a QOF's income each year even if the fund does not make distributions. In addition, the way that basis rules apply to QOFs is unclear in certain respects.

Taxable distributions. An investor cannot enjoy the Basis Step-Up or Ten-Year Benefit on any QOF interests that an investor sells before meeting the applicable holding period requirement. A QOF distribution can be treated as a sale of a portion of the investor's interests if the distribution is taxable, which would occur if a QOF distribution is greater than the investor's basis. A reduction in the investor's share of partnership liabilities is also treated as a distribution for this purpose. A QOF may be unwilling to foreclose entirely the possibility of such a taxable distribution, so that it can sell or refinance an underlying investment when market conditions are favorable.

Tax risks upon exit
Exit through sale in 10 years. The Ten-Year Benefit is only available if the investor sells the QOF interests or the QOF sells its assets after a holding period of at least 10 years. There is no guarantee that such sales can be made, particularly in 10 years when other QOFs will also be pursuing similar objectives.

QOF may structure exit so that Ten-Year Benefit is not available. A QOF may sell a property earlier than 10 years and distribute the proceeds, or otherwise structure an exit in a manner that would not permit the investor the enjoy the Ten-Year Benefit.

Fund must qualify (and maintain qualification) as QOF
As noted above, if a fund loses its status as a QOF, OZ tax benefits will be lost. This qualification faces the following risks:

1. *90% QOF asset test.* For a fund to qualify as a QOF, every six months, it must have at least 90% of its assets invested in qualifying investments, which consist of interests in subsidiary qualified OZ businesses and direct investments in qualified OZ business property. The regulations favor a two-tier structure in which the QOF invests cash in a subsidiary (interests in which are immediately treated as qualifying investments for the QOF), which must invest at least 70% of its assets in qualifying OZ business property and has up to 31 months to deploy the cash, pursuant to a written plan, in acquiring, developing or rehabilitating a qualifying property. These requirements place a premium on deal flow.

2. *Commercial issues.* A fund may fail to qualify as a QOF for non-tax reasons beyond its control, such as financing issues, zoning issues, disputes with co- investors, etc. A co-investor in a subsidiary may have divergent interests if it is not seeking OZ tax benefits.
3. *Penalty or Disqualification.* The statute provides for a monthly penalty, based on the underpayment rate (3% per annum for the calendar quarter beginning January 1, 2022), to the extent of QOF assets that do not meet the 90% test. It is unclear whether continued non-compliance by a QOF or an asset-holding subsidiary would at some point disqualify the fund.
4. *Qualification until exit.* The fund must qualify as a QOF until the date on which the investor sells its QOF interests or the QOF sells its underlying assets. A fund may commit to maintain QOF status only for certain period of time—for example, 10 years beyond the last investment by an investor seeking OZ tax benefits. This could effectively force a sale when this commitment expires, regardless of the market at that time.

The risks associated with investing in a private equity fund generally include:

– Limited Regulatory Oversight—Since private equity funds are typically private investments, they do not face the same oversight and scrutiny from financial regulatory entities such as the Securities and Exchange Commission ("SEC") and are not subject to the same regulatory requirements as regulated investment companies, (i.e., open-end or closed-end mutual funds) including requirements for such entities to provide certain periodic pricing and valuation information to investors. Private equity offering documents are not reviewed or approved by the SEC or any US state securities administrator or any other regulatory body. Also, managers may not be required by law or regulation to supply investors with their portfolio holdings, pricing, or valuation information.
– Portfolio Concentration; Volatility—Many private equity funds may have a more concentrated or less diversified portfolio than an average mutual fund. While a more concentrated portfolio can have good results when a manager is correct, it can also cause a portfolio to have higher volatility.
– Strategy Risk—Many private equity funds employ a single investment strategy. Thus, a private equity funds may be subject to strategy risk, associated with the failure or deterioration of an entire strategy.
– Use of Leverage and Other Speculative Investment Practices—Since many private equity fund managers use leverage and speculative investment strategies such as options, investors should be aware of the potential risks. When used prudently and for the purpose of risk reduction, these instruments can add value to a portfolio. However, when leverage is used excessively and the market goes down, a portfolio can suffer tremendously. When options are used to speculate (i.e., buy calls, short puts), a portfolio's returns can suffer and the risk of the portfolio can increase.
– Valuations—Further there have been a number of high profile instances where private equity fund managers have mispriced portfolios, either as an act of fraud or negligence.
– Past Performance—Past performance is not necessarily indicative and is not a guarantee of a private equity fund's future results or performance. Some private equity funds may have little or no operating history or performance and may use hypothetical or pro forma performance that may not reflect actual trading done by the manager or advisor and should be reviewed carefully. Investors should not place undue reliance on hypothetical or pro forma performance.
– Limited Liquidity—Investors in private equity funds have limited rights to transfer their investments. In addition, since private equity funds are not listed on any exchange, it is not expected that there will be a secondary market for them. Repurchases may be available, but only on a limited basis. A private equity fund's manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the private equity fund.
– Tax Risks—Investors in certain jurisdictions and in private equity funds generally may be subject to pass-through tax treatment on their investment. This may result in an investor incurring tax liabilities during a year in which the investor does not receive a distribution of any cash from the Fund. In addition, an investor may not receive any or only limited tax information from private equity funds may not receive tax information from underlying managers in a sufficiently timely manner to enable an investor to file its return without requesting an extension of time to file. In certain jurisdictions a lack of tax information may result in an Investor being taxed on a deemed basis at an adverse rate of tax.
– Fees and Expenses—Most private equity funds charge both an asset-based management fee and a performance-based incentive fee or allocation. As a result, the fees and expenses associated with Hedge Fund investing may exceed those of a long-only mutual fund.
– Reliance on Fund Manager; Lack of Transparency—A private equity fund's manager or general partner has total investment authority over the private fund. There is often a lack of transparency as to a private equity fund's underlying investments. Because of this lack of transparency, an investor may be unable to monitor the specific investments made by the private equity fund or to know whether the investments are consistent with the private equity fund's historic investment philosophy or risk levels. Due to the risks mentioned above, it is important to perform proper due diligence in evaluating and choosing private equity fund managers to place your money with. There have been occasions when private equity fund managers took on too much risk in their portfolio and lost a substantial amount of their investors' money.

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