



July 30, 2021

The Office of the Honorable Cory Booker
United States Senate
717 Hart Senate Office Building
Washington, D.C. 20510

Re: Impacts of Proposed Capital Income Taxation Reform on the Opportunity Zones Incentive

Dear Senator Booker:

On May 28, 2021, the US Treasury's released the General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, otherwise known as the Green Book. The Green Book summarizes the Biden Administration's views on current and future tax policy and lists a number of proposals for new tax legislation. Some of the proposed legislation, if enacted, would negatively impact the Opportunity Zones (OZ) incentive that Senator Booker originally co-sponsored in the Investing in Opportunity Act of 2016 and which became law in 2017. The Novogradac Opportunity Zones Working Group (the OZ Working Group) is writing you to identify certain elements of the Green Book proposal that would be detrimental to the OZ incentive and to recommend amendments to the proposal that would preserve the intended scope of your legislation.

The OZ Working Group includes investors, syndicators, lenders, community development entities (CDEs), community development financial institutions (CDFIs), for-profit and nonprofit developers, consultants, law firms, and other community development professionals who work together to suggest consensus solutions to technical OZ incentive issues and provide recommendations to make the OZ incentive more efficient in delivering benefits to low-income communities.

Novogradac is a national professional services organization. With 28 offices across the country – including offices in Iselin and Toms River, NJ serving clients throughout the state and the mid-Atlantic region – the Novogradac organization consists of affiliates and divisions providing professional services that include certified public accounting, valuation and consulting.

Proposal to Increase Long-Term Capital Gains Tax Rates

The Green Book contains two proposals to increase the long-term capital gains tax rates from the current highest rate of 20 percent (23.8 percent including the net investment income tax). The first would be to tax capital income for high-income earners at ordinary rates. Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than \$1 million would be taxed at ordinary income tax rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax), but only to the extent that the taxpayer's income exceeds \$1 million (\$500,000 for married filing separately), indexed for inflation after 2022. A separate proposal would return the top marginal ordinary income tax rate to 39.6 percent, the rate in effect prior to the Tax Cuts and Jobs Act, which would result in a total long-term capital gains tax rate of 43.4 percent, including the net investment income tax.

The OZ incentive is designed to reward long-term investments into distressed communities through temporary deferral of capital gains invested in a qualified opportunity fund (QOF), partial exclusion of those gains for



investments held for 5 and 7 years, and permanent exclusion of any gains realized on QOF investments held for 10-years. Taxpayers are required to recognize any gain that has been deferred through a qualifying investment in a QOF by December 31, 2026 at the latest. Under current law, when gain that was previously deferred is included in income, the gain is taxed at the federal income tax rates in effect on the date of inclusion. Accordingly, any increase in the capital gains tax rate abates the incentive that influenced taxpayers to invest in these distressed areas and the doubling of capital gain tax rates as proposed could eliminate any incentive whatsoever.

Therefore, in order to in order to fulfill Congresses' purpose of rewarding long-term investments into distressed communities, we recommend that the OZ statute be amended to provide that when gain that was previously deferred is included in income, the gain is taxed at federal income tax rates in effect on the date of the deferral, not the tax rates prevailing at the date of inclusion as is required under current law.

Please see below for suggested amendment to section 1400Z-2 to enact this proposal:

Section 1400Z-2(b)(2)(C): Inclusion year treatment. The gain so included per subsection (b)(2)(b) is subject to the same Federal income tax provisions and rates that would have applied to any other gains that would have been realized and recognized in the year of deferral and that would have the same attributes as the deferred gain.

Proposal to Treat Transfers at Death of Appreciated Property as Realization Events

Under current law, when an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. As a result, the amount of appreciation accruing during the decedent's life on assets that are still held by the decedent at death permanently escapes federal income tax. appreciated assets that are transferred at death are generally stepped up to the fair-market value of the assets as of the date of the decedent's death. This has generally resulted in no taxation on any unrealized gains that occurred during the decedent's holding period of the assets. In order to encourage individuals to recognize and invest these unrealized gains, the final OZ Treasury Regulations contain a special exception whereby an investment in a qualified opportunity fund is not stepped up to its fair market value and instead, maintains its OZ benefits when transferred to a decedent. This encourages long-term investment and enables multi-generational investors to avail themselves of the benefits of the OZ incentive.

Under a Green Book proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. For a decedent, the amount of gain would be the excess of the asset's fair market value on the decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the decedent on the Federal gift or estate tax return or on a separate capital gains return.

The proposal provides for certain exclusions from recognition including capital gain on certain small business stock under section 1202 of the Internal Revenue Code (IRC).

Under the final opportunity zones regulations, a transfer of a qualifying investment by reason of a taxpayer's death is generally not an inclusion event. Thus, a qualifying investment is able to transfer by reason of death without triggering inclusion of the deferred gain. If a taxpayer receives a qualifying investment in a QOF by reason of the prior owner's death, the investment continues to be a qualifying investment in the taxpayer's hands and the taxpayer's holding period for the qualifying investment includes the time that the deceased owner held the interest. In other words, the holding period tacks. With respect to any gain that the decedent elected to defer but has not yet recognized, the person in receipt of the qualifying investment from the decedent will include that gain in gross income for the taxable year in which an inclusion event occurs.

Example: On August 1, 2020, Taxpayer, an individual, contributes \$500,000 of eligible gain to a QOF in exchange for a qualifying investment in the QOF and makes a valid deferral election under §1400Z-2. Taxpayer's initial basis

in the qualifying investment is zero. Taxpayer dies in 2023 and Taxpayer's heirs inherit the qualifying investment in the QOF. The transfer by reason of death is not an inclusion event. The heir's basis in the qualifying investment in the QOF is \$zero. This is true regardless of the fair market value of the qualifying investment at the time of Taxpayer's death. On December 31, 2026, the taxpayer's heirs recognize \$450,000 of previously deferred gain (\$500,000 minus the \$50,000 statutory basis adjustment for holding period of 5 years).

Under the Green Book proposal, Taxpayer in the above example would be required to recognize \$500,000 plus appreciation occurring on the QOF investment during the Taxpayers holding period. This proposal effectively makes a transfer on death an inclusion event and prevents any appreciation occurring on the QOF investment during the Taxpayers holding period from being eligible for the 10-year gain exclusion, thereby creating a result that was clearly not intended in the statute.

Accordingly, we recommend that any proposed legislation include an exclusion from recognition of capital gain for any qualified investments in a QOF similar to the proposed exclusion for certain small business stock under IRC section 1202.

Please see below for suggested legislative language to enact this proposal:

Coordination of the recognition rule with section 1400Z-2. In the case of a decedent, amounts recognized under this section shall not include gains realized from qualified opportunity fund investments held by the decedent.

We welcome the opportunity to speak with you further on ways to ensure that the scope of your opportunity zone legislation is not unintentionally harmed by new law. One action we would hope the Senator would consider would be for him to file an amendment to the FY 2022 budget resolution expressing the sense of the Senate to hold the OZ incentive harmless from any proposed capital gains taxation reform. We would be happy to discuss this idea further with you.

Thank you for your leadership and strong commitment to opportunity zones. Should you have any questions or comments, please call me directly at 330-365-5409.

Very truly yours,



John S. Sciarretti
Partner