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Preparing Opportunity Zone Investors For Higher Capital Gains.

Will clients who've taken advantage of recent tax breaks for economic development soon regret their decision?

Qualified opportunity zones (QOZs) were established as part of 2017's tax reform. A key attraction of investments in this program is deferred capital gains taxes. President Joe Biden's proposed tax changes could increase the latter significantly—meaning investors might pay more tax when the deferment ends.

The recent American Families Plan bumps up taxes for wealthy taxpayers—including increasing the tax rate on long-term capital gains from the current 20% for households making more than $1 million. QOZs provide tax incentives for long-term investments in certain low-income communities, the biggest being deferment of recognized capital gains until the end of 2026.

Taxpayers with these deferred capital gains might, however, then face the 2026 rate, which under Biden's proposal could be 39.6% for wealthy taxpayers. It's unknown now if the Biden proposal will grandfather in QOZ investors at the current lower capital gains rates.

But advisors still advantages to these investments.

"Overall, we expect Opportunity Zone investments—and other tax-advantaged investments—will be more attractive in a higher-rate environment, since the tax savings they yield will be more meaningful," said Chris Catarino, CPA and shareholder at Drucker & Scaccetti in Philadelphia. "It is possible that investments into QOZs could temporarily freeze up until the higher tax rates go into effect."

"We actually think that the tax increase may enhance the attractiveness of QOZ investments," added Aaron Brachman, Washington, D.C.-based managing director, wealth manager and founding partner at Washington Wealth Group at Steward Partners.

Biden's proposal could hurt capital gains deferment, Brachman admitted, but enhance the program's other two main benefits:

• Appreciation of the new property is exempt from capital gains if held in accordance with all QOZ guidelines. If the property sees appreciation, this is the most powerful benefit by far. It is further enhanced if the capital gains rate is near 40%.

• Investors can depreciate properties to offset the income received to the investor. If the property is, again, held in accordance with all QOZ guidelines "they should not see any depreciation recapture upon sale," Brachman said. "This essentially provides a highly tax efficient stream of income that won't be penalized with recapture upon sale."

An often-overlooked aspect of the Biden plan is the proposed elimination of IRC Section 1031 "like-

kind” exchanges. And “most qualified opportunity funds today invest in real estate projects and plan to use this provision of the code to cycle through a handful of different projects during their 10-year life without incurring any tax friction,” Catarino said. “Elimination of 1031 exchanges would prevent these funds from executing this plan.

“It will be interesting to see if the Biden administration proposes increased reporting requirements on Opportunity Zone funds to monitor and evaluate the program’s impact on the communities,” he added. “The reporting requirements have been fairly minimal in comparison to the tax benefits.”

The year 2026 is also after the next presidential election. “Even if the income tax rates on capital gains go up under President Biden, it’s possible the rates could come down under the next administration,” Catarino said.

An investing plan to realize a few years’ return on the money for the eventual tax bill—should capital gains rise as much as proposed—is one strategy. Also, advise patience to clients who invested in QOZs and who fear tax changes, advisors say.

“The most significant tax benefit of QOZ investing is that capital gains realized on the sale of an investment held 10 years or more are essentially tax-free due to a basis step-up,” Catarino said. “Investors should be taking the long-view. Maybe they will have to pay more tax in 2026 from a rate swing, but the payoff even further down the line could be far more beneficial.”

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