Qualified Opportunity Fund Investments

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Advantages of Investing in a Qualified Opportunity Zone Fund

The Tax Cuts and Jobs Act (TCJA) authorized the creation of qualified opportunity zones with tax incentives for those taxpayers willing to invest. Specifically, the TCJA allows for re-investment of gains into qualified opportunity funds (QOFs). QOFs are privately managed investment vehicles which allow their investors to indirectly invest in the opportunity zone. Investing in a QOF allows taxpayers to defer and potentially exclude capital gains.

Deferred Capital Gains

- Taxpayers who elect to utilize this vehicle will be able to defer the realization of capital gains by rolling them into a QOF.

- A taxpayer can elect to temporarily defer gains from the sale or exchange of property to the extent that the taxpayer invests the gain(s) in a QOF within 180 days of the date of the sale or exchange. Note that a taxpayer need not reinvest all of the proceeds from the sale or exchange to benefit from the deferral, but this benefit is only available to the gains from the sale or exchange of the original property that a taxpayer invests in a QOF and elects to defer. The election is only available for sales or exchanges on or before December 31, 2026.

- Investing in a QOF can allow for the deferral of taxation for a taxpayer's qualifying gain until the earlier of (1) the date on which the taxpayer disposes of the investment in the QOF or (2) December 31, 2026. Note, the recognition from either event will be the lesser of either (1) the remaining deferred gain, less any applicable basis step-up (discussed below), or (2) the fair market value of the investment in the QOF, less any applicable basis step-up.

- Amounts invested in a QOF are treated as deferring an equal amount of gain. As a result, the original gain invested in a QOF can be completely deferred as long as the investment equals or exceeds the amount of on the original gain. Note, QOF benefits, including the permanent exclusion of any gain from the appreciation of the QOF itself, are only available to the gains invested in the QOF which are subject to the election. No additional amounts invested in the QOF are eligible for any of these benefits.

- Example 1: Taxpayer sells property and realizes a gain of $50 million on December 11, 2018 and invests the entire $50 million gain in a QOF within 180 days of sale. Assuming Taxpayer made an election to treat its investment as a deferral, Taxpayer will not include the $50 million of realized gain in her gross income for the 2018 tax year.

Exclusion of Capital Gains

Reinvesting capital gains in a QOF can lead to gains potentially being excluded both through a basis increase related to the original deferred gain, which was reinvested, as well as an exclusion provision that focuses on the appreciation of the gain in the QOF.

Reduction of Deferred Capital Gains

- A taxpayer's income tax basis in its reinvested capital gains in a QOF Opportunity Zone Fund is initially zero assuming the amount invested in the QOF does not exceed the gain to be deferred. However, taxpayers who meet certain holding period requirements may benefit from a step-up in basis in connection with the original deferred capital gain.

- Simply put, a taxpayer who invests in a QOF may be able to permanently exclude some of the originally deferred gain discussed in the previous section (between 10% and 15% depending on holding period).

- Investments in QOF may have 10% of the original gain eliminated if the taxpayer holds the investment for at least 5 years. Moreover, this benefit can increase by an additional 5% if the investment is held for a total of at least 7 years, potentially reducing the original deferred gain by 15%.

- Example 2: Assume the same facts as Example 1, i.e., Taxpayer invests a $50 million gain in a QOF on December 11, 2018. If Taxpayer disposes of the investment in the QOF before December 11, 2026, but after December 11, 2023 (i.e. she held the investment for at least 5 years), Taxpayer would not be subject to tax on $5 million of the original $50 million deferred gain. Additionally, if Taxpayer were to hold the investment until December 11, 2025 (i.e. at least 7 years), then Taxpayer would not be subject to tax on an additional $2.5 million, which would make a total of $7.5 million of the original $50 million deferred gain that would be permanently excluded from taxation.

Additional Exclusion of Certain Capital Gains

- If a taxpayer elects to hold an investment in a QOF for at least 10 years, a taxpayer may permanently exclude gains from any appreciation of the QOF itself.

- As mentioned in the first section, taxpayers who make a deferral election have to recognize any such deferred gain on December 31, 2026, or if prior to that date, the date on which a taxpayer disposed of an investment in a QOF. They do not, however, have to recognize any gain from the appreciation of the QOF until they actually dispose of that investment, which may include some of the gain originally deferred if the value of the fund on December 31, 2026 is less than the amount of gain originally invested. As a result, a taxpayer who holds a QOF for at least 10 years may elect to step up the income tax basis of the investment in the QOF to the fair market value of that investment on the date of disposition and not pay any income tax on any appreciation that result after acquiring the QOF.

- Thus, a taxpayer who invests in a QOF and holds that investment at least 10 years may be able to:
    a) Defer the original gain until the earlier of (1) the date on which the taxpayer disposes of the investment in the QOF or (2) December 31, 2026;
    b) Receive up to a 15% percent step-up in basis and thereby permanently exclude some of the original gain invested; and
    c) Exclude all of the gain related to the appreciation of the QOF itself.

- Example 3: Assume the same facts as Examples 1 and 2, i.e., Taxpayer invests a $50 million gain in a QOF on December 11, 2018. On December 11, 2028, Taxpayer sells the investment in the QOF for $150 million, i.e., the value of the investment has appreciated by $100 million. Assuming the value of the QOF on December 31, 2026 was at least $50 million, the following would result:
    a) None of the $50 million in gain would have to be reported in 2018.
    b) On December 31, 2026, Taxpayer will only recognize $42.5 million of gain ($50M*85%) as opposed to the original deferred gain at $50 million. The basis in Taxpayer's QOF investment will increase to $50 million due to this gain recognition.
    c) When Taxpayer sells the QOF for $150 million, no gain will be taxed. The $100 million of appreciation in the QOF investment is excluded because Taxpayer held the QOF for 10 years.

Questions Remain

Some questions remain from the language creating the QOFs in the TCJA.

- How and when a taxpayer makes the election to defer the recognition of the capital gains rolled into a QOF. For example, will the benefits discussed above be available for those who invest after 2022? If an investor in a QOF is unable to hold an investment for the 5- or 7-year period required for basis step-up prior to the December 31, 2026 recognition date, will they receive any benefit from the step up?

- How and when a taxpayer who holds a QOF investment for 10 years makes the election to exclude the gain from the appreciation of the fund. Currently, the statutory and regulatory authority calls for the expiration of all opportunity zones (and, thus, all QOFs) at a date prior to when a taxpayer that invests after 2018 could hold a QOF investment for the 10 years required to utilize the additional exclusion of certain capital gains discussed above. As a result, what would happen if a taxpayer invests in a QOF, but would not have held the investment for one of the above mentioned statutory periods?

  a) For example, Taxpayer invests in a QOF in 2020, will Taxpayer be permitted to hold the QOF until 2030 to qualify for the permanent exclusion of gains related to the appreciation of the QOF, or would this benefit be lost to Taxpayer?

The Treasury still has the opportunity to provide clarification on these points, until then, taxpayers who invest in QOFs after 2018 risk not being able to take advantage of all the benefits QOFs have to offer.

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