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Private Wealth Management

# Investing in Qualified Opportunity Funds

## A new investment opportunity that offers substantial tax benefits, but not without investment risk

Qualified Opportunity Funds are a new investment opportunity designed to drive development in economically distressed areas. They come with significant tax benefits, but the holding requirements and other risks mean they aren't suitable for all investors.

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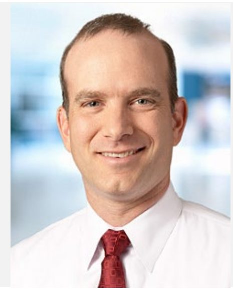

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Investors looking for opportunities to defer recognizing a capital gain have traditionally been limited to a few specific techniques that only apply to certain types of gains, typically real estate or small businesses. However, thanks to a provision in the 2017 Tax Cuts & Jobs Act (TCJA), a new investment opportunity has been created that offers more flexibility – and even better tax advantages – than nearly any other strategy available today.

Qualified Opportunity Funds, or QOFs, are a new vehicle designed to drive investments in low-income communities (known as Qualified Opportunity Zones, or QOZs) throughout the United States. To encourage these investments, QOFs offer a unique triple-play of tax benefits – the ability to defer the tax on capital gains that are rolled into the QOF, a partial exclusion of that gain after a period of time, and tax-free growth for long-term investors in the QOF. Like all investment opportunities, however, these QOFs do present some risks, so investors need to avoid being blinded by the tax benefits and instead evaluate these on their overall investment merits.

### QUALIFIED OPPORTUNITY ZONES

QOZs are geographic areas that have been certified by the US Treasury as meeting the qualifications established in the TCJA, such as areas with high poverty rates or where family incomes are well below averages for the broader geographic area. Governors submitted recommendations for areas to be designated as QOZs, and the US Department of the Treasury made the final determination as to what areas qualify. Once an area has been designated a QOZ, that designation remains in place for at least 10 years, but no later than December 31, 2047.

There are over 8,700 census tracks throughout all 50 states and the District of Columbia, plus Guam, Puerto Rico and other US territories. A full list of the qualifying areas, including an interactive map, can be found at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

### QUALIFIED OPPORTUNITY FUNDS

QOFs are the vehicles by which investors can make QOZ investments and receive the unique tax benefits. QOFs are organized as either partnerships or corporations (including Real Estate Investment Trusts, or REITs), and nearly any type of investor can place money in the QOF. They are not a mutual fund or similar investment, as the QOF name may suggest.

Individuals can invest directly in a QOF, as can any type of corporation, partnership, trust or estate, among others. The QOF itself can be a pre-existing entity that elects to be a QOF or a new entity established solely for the purpose of a QOZ investment, but it must certify to the IRS that it meets the requirements to be a QOF on an annual basis. This certification is done via Form 8996, and is included in the tax return for the entity for each year it wants to be treated as a QOF.

The primary requirement to be a QOF is that at least 90% of the QOF's assets must be invested in Qualified Opportunity Zone Property (QOZP), which is defined below. Only new investments in QOZP are allowed – any property owned by the QOF before the date it certifies to be a QOF doesn't count toward the 90% requirement.

QOFs are given some leeway in meeting that 90% requirement, however, when it comes to maintaining working capital within the entity. As a QOF solicits investments, it can keep that cash within the entity for up to 31 months before it must be invested in QOZP. This gives QOF sponsors the flexibility to take investments and then hold the funds until they find the right QOZP opportunity.

## QUALIFIED OPPORTUNITY ZONE PROPERTY

Within QOZs, only certain types of investments meet the standards to be considered Qualified Opportunity Zone Property (QOZP). In order for the QOF investor to qualify for the unique tax benefits, at least 90% of the QOF's assets must be invested in QOZP. These investments can be done in either or both of the following forms:

1. Direct ownership in QOZP.
2. Indirect ownership in QOZP by investing in a corporation or partnership that invests in QOZP.

To qualify as direct ownership in QOZP, the property must be tangible property (buildings, equipment, machinery, etc.) that is used in a trade or business and is acquired by the QOF after December 31, 2017.

- If this is existing property within the QOZ, it must be substantially improved by the QOF (such as redevelopment of a dilapidated building) within 30 months of acquiring the property.
- If this is new property, its first use by the QOF must be inside the QOZ. Typically this will mean a new construction of some kind, but it can also mean purchasing and then relocating existing machinery, etc. into the QOZ from a different location.

For indirect ownership of QOZP, the underlying corporation or partnership must meet additional requirements:

- At least 70% of the business's assets must be direct ownership of QOZP. This allows a business to be established inside a QOZ while also having at least some other non-QOZP assets.
- At least 50% of the business's income must be generated inside the QOZ.
- The business can't be a golf course, country club, massage parlor, hot tub or suntan facility, liquor store or a racetrack or other gambling facility.

## INVESTING IN A QOF

In order to encourage the use of QOFs, the TCJA provided multiple tax incentives to investors. To take advantage of those incentives, however, **a taxpayer must first realize a capital gain** and **then reinvest that gain into a QOF**. Beyond that, the rules give potential investors significant flexibility when considering QOFs:

- QOF investments can come from the sale of any asset that results in a capital gain, including the sale of stock, mutual funds, collectibles, real estate, businesses, etc. Even mutual fund capital gain distributions can be invested in a QOF.
- All types of investors can invest in a QOF, including individuals, corporations and pass-through entities.
    - If a pass-through entity realizes a gain but does not reinvest the gain into a QOF itself, the individual to whom it passes can then make the investment. This includes partners in a partnership, shareholders of an S Corporation, and beneficiaries of a trust or estate, among others.
- The reinvested gain can be either a short-term or long-term gain.

- Only the gain portion of the sales proceeds must be invested in the QOF, not the entire amount.
    - **Example 1**: An investor sells shares of stock for $500,000 and realizes a gain of $300,000. To maximize the benefit of the QOF, only the $300,000 representing the gain must be invested in the fund. The additional $200,000 of sales proceeds can be used by the seller however they wish.

In order to take advantage of these incentives, the gain must meet several requirements:

- The gain must have been realized after December 31, 2017, but before January 1, 2027.
- The gain must be reinvested in the QOF within **180 days** of the sale that triggers the gain.
    - Gains that come from a pass-through entity, like a partnership or trust, are deemed to be realized on the last day of that entity's tax year. Typically that would be December 31, but not always. The end taxpayer in those cases would then have 180 days from that date to roll the gain into a QOF.
- The gain must otherwise be a capital gain that would have been taxable. Gains that are excluded from income or that are reclassified as ordinary income are not eligible.
    - **Example 2**: A rental property is sold for a gain of $250,000. Due to the depreciation recapture rules $150,000 of the gain is must instead be treated as ordinary income. Only the remaining $100,000 treated as a capital gain can benefit from the tax advantages of the QOF.
- The gain can't be a result of a sale to a related party, such as a parent, child or sibling, among others.

Investors can make a QOF investment that is larger than their realized capital gains for the year. However, those investments are considered separate from ones made with qualifying gains and will not benefit from any of the tax advantages available to QOF investments.

- **Example 3**: Building off Example 1 above – The investor also places an additional $60,000 into a QOF. That $60,000 investment will be considered completely separate from the $300,000 investment made with the realized gain, and will not participate in any of the tax benefits available to the $300,000 investment.

## TAX BENEFITS OF INVESTING IN A QOF

Once an investor has realized a qualifying capital gain and then rolls that gain into a QOF, they are eligible for the following tax benefits:

1. **Gain Deferral** – The gain was invested in the QOF is not included in taxable income in the year it's realized. Rather, the gain is not taxable until the QOF is sold, but no later than December 31, 2026.
2. **Basis Adjustment** – Once the investor has held the QOF investment for five years, their cost basis is increased by 10% of the amount of the original gain that was deferred. If the QOF is held another two years after that, the basis is increased by another 5% of the deferred gain.
3. **Tax-Free Growth** – If the investor holds the QOF investment for at least 10 years, any gain realized upon the sale of the investment is exempt from tax.

While these tax benefits will be attractive to potential QOF investors, each item comes with varying caveats and complicating factors.

1. **Gain Deferral**
    - Because the gain that is invested in the QOF is not considered taxable income, the investor's initial cost basis in the QOF defaults to $0.
    - The <u>deferred gain will be deemed taxable</u> upon the earlier of the sale, exchange or transfer of the QOF, even if due to the death of the QOF owner, or December 31, 2026.

- In any of those cases, the recognized gain is equal to the lesser of the original deferred gain or the current market value of the investment, minus any cost basis adjustments made under the Basis Adjustment rules below. In other words, a decline in the value of the QOF after the original investment reduces the amount of gain to recognize.
- In the case of the death of the QOF owner, the deferred gain is considered Income in Respect of a Decedent and is taxable to the beneficiary. Unlike other assets in a decedent's estate, there is no step-up in basis to eliminate that gain.
- The recognized gain maintains the same tax treatment it had at the time it was originally realized. For example, if a short-term capital gain was reinvested into the QOF, it will be a short-term gain when it's ultimately taxable. The gain is treated as being realized in the year of the triggering event, however, making it subject to the tax rates and other rules in place at that time.
- If the investor continues to hold the QOF beyond December 31, 2026, their basis in the investment is increased by any gain recognized on that date.
- Investors can make multiple investments into a single QOF, but each investment will be tracked separately. These multiple investments can all come from the same original gain (but all made within the same 180 day period) or from realizing multiple, unrelated capital gains.
- If the investor sells 100% of their QOF investment and realizes a gain, that gain can be rolled into a new QOF and continue the deferral. However, in order to defer any of that gain, it must also be invested in the new QOF within 180 days of the sale AND before January 1, 2027.
  - That deferred gain would then be subject to tax as of December 31, 2026, just as the gain from the original QOF investment would have been.

2. **Basis Adjustment**
   - In addition to deferring the original gain, up to 15% of that gain can be completely excluded from income via the basis adjustment provisions.
     - **Example 4**: Building off Example 1 above, assume the gain was realized in June 2019. In September of that year (within the 180 day requirement) the entire $300,000 was invested in a QOF. The initial cost basis of the QOF is $0.
       - In September 2024, five years after the initial QOF investment, the basis is increased to $30,000 ($300,000 gain x 10%).
       - In September 2026, seven years after the initial QOF investment the basis is increased by another $15,000 ($300,000 gain x 5%) for a total basis of $45,000.
       - In December 2026, the remaining $255,000 of original gain ($300,000 gain – $45,000 basis) is recognized.
   - However, in order to receive the **maximum 15% basis increase**, the investor would need to meet the **seven-year holding requirement before December 31, 2026**. Once the deferred gain is triggered, no further basis adjustments under this rule are allowed.
     - **Example 5**: Building off Example 4 above, except that the gain was instead realized in November 2019 and wasn't invested in the QOF until February 2020.
       - In February 2025, after five years, the investor's cost basis is increased to $30,000.
       - As of December 31, 2026, the remaining gain of $270,000 becomes taxable.

        - Because the seven-year anniversary of the investment was not until February 2027, the investor is not eligible for the additional 5% basis increase.

    - This means that any investment in a QOF after December 31, 2019 will not receive the full 15% increase. If the investment in the QOF is made after December 31, 2021, the investor will not be eligible for either the 10% or 5% basis adjustment, although the initial investment will still qualify the original gain deferral until the end of 2026.
    - This basis adjustment does not apply to any growth in the value of the QOF after the initial purchase. The tax treatment of that gain is addressed in the following point.

3. **Tax-Free Growth**
    - Investors who hold their QOF investment for at least 10 years before selling it can exclude any appreciation beyond the beyond their cost basis.
        - **Example 6**: Building off Example 4 above, in 2030 the investor sells the QOF for $700,000. The adjusted basis in the QOF was $300,000 resulting in a $400,000 capital gain. However, because they held the QOF for more than 10 years, that gain is exempt from tax.
    - Investors are not required to sell their QOF after 10 years, but that is the minimum holding period needed to avoid the gain.
    - However, the rules do require investors to sell 100% of their QOF investment no later than December 31, 2047 in order to receive this 100% gain exclusion.

## IMPORTANT QOF INVESTMENT CONSIDERATIONS

The tax advantages available to QOF investments can be very attractive to those investors looking to defer the tax on a realized capital gain. However, as with any investment product, there are a variety of non-tax considerations and other risks that should be addressed.

- The investments made within the QOF (the QOZP) must meet a variety of very strict requirements. In many cases these will often be real estate-oriented investments – hotels, apartment buildings, parking garages, storage units, etc. Investors should consider whether those types of investments fit well within their portfolio. Remember that the QOF isn't the investment, but rather is the vehicle for investing in the underlying QOZP, just like a mutual fund is basically a vehicle for investing in stocks or bonds.
- Because of the complexity of the QOF structure, sponsors are likely to require relatively high minimum investments to participate. Many of the early offerings start at $100,000, but others have minimums as high as $1 million.
- In order to maximize the tax benefits, investors should plan on holding their QOF investment for at least 10 years. Investments in these funds should not be considered a place to hold money while waiting for another investment opportunity.
- Along those lines, some QOFs are imposing lock-up periods on their investors. The QOF will need time to collect investments, identify the right QOZP and then complete the redevelopment of the property or establishment of the new business. Lock-up periods of 12 years are not uncommon.
- As with all investments, the expenses associated with the QOF must be considered. Each QOF will assess some type of overlying management fee, just like any other investment. In partnership structures, there may also be a preferred return paid to the general partners before earnings are shared with other investors. These expenses may be justified by the quality of the team running the QOF, and the tax advantages can help offset these costs as well, but like any investment those expenses will reduce the total return earned by investors.