Qualified Opportunity Funds: How Do They Work?

BY SANDRA F. O'NEILL • FEBRUARY 13, 2020

The Tax Cuts and Jobs Act of 2017 created the Opportunity Zone program under section 1400Z of the Internal Revenue Code ("1400Z"), which provides investors with a new tool to defer gains from sales or exchanges of capital assets. The Opportunity Zone program aims to stimulate investment in economically disadvantaged areas by offering the possibility to defer capital gain recognition and avoid capital gains on the appreciation of an Opportunity Zone investment after a 10-year holding period. Here is an example of how a taxpayer might use the program.

In January 2020, taxpayer, Ada, sells $1,000,000 of shares in Apple stock that she purchased for $200,000. She would like to reinvest her gains in a brewery she is considering opening in a designated opportunity zone in Worcester. Under section 1400Z-2 of the Code, she can defer tax on her $800,000 gain, if she invests it in a qualified opportunity fund. She can also keep $200,000 (her basis in the sold shares) without paying tax. Ada must submit IRS Form 8949 with her federal income tax return showing her Apple stock sale to elect application of this opportunity zone deferral.

Within 180 days from the day she sells her Apple shares, Ada must invest the $800,000 gain in a qualified opportunity fund. Under the final Treasury Regulations, a qualified opportunity fund is a corporation or partnership that certifies (on an annual basis) that 90% of its assets are "qualified opportunity zone property." To self-certify, the fund must submit IRS Form 8996 annually with its federal income tax return. Ada can form a corporation as a qualified opportunity fund in June 2020 and contribute the $800,000 Apple gain to the corporation. The corporation has 31 months to spend this $800,000 according to a written plan to open the brewery.

If Ada holds onto her qualified opportunity fund investment for at least five years, 10% of her $800,000 Apple gain will be exempt from tax. Her remaining deferred gain will be taxed on December 31, 2026 (or the date she sells her investment, if earlier). This is a material benefit to the taxpayer. In addition, if Ada holds onto her investment for at least 10 years, she can sell her brewery investment without paying federal income tax on subsequent gain.

The new rules provide significant flexibility on how to structure a qualified opportunity fund investment. Contact us for more information on establishing a qualified opportunity fund and investing in qualified opportunity zone property.