Qualified Opportunity Funds: Ten Issues to Keep in Mind

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The Tax Cuts and Jobs Act signed into law at the end of 2017 created a tax incentive aimed at increasing economic development in low-income communities. The law generally allows a taxpayer to defer paying taxes and “roll over” a capital gain into a Qualified Opportunity Fund. Qualified Opportunity Fund investments create three potential tax savings opportunities (assuming a timely election is made on the applicable tax returns and other eligibility requirements are met):

1) immediate deferral of gain if proceeds from the sale of any property (including stocks and real estate) are invested in a Qualified Opportunity Fund within a given time period (the “Deferral Benefit”);

2) permanent exclusion of 10% or 15% of the deferred gain from taxation depending on how long the investment is held (the “10% or 15% Benefit”); and

3) exclusion from taxation on any appreciation in the fund if the investment is held for at least 10 years prior to sale (the “Exclusion Benefit”).

A tremendous amount has been written about Qualified Opportunity Funds (“QOFs”), the potential tax benefits to investors, and the potential economic benefits to communities. However, lack of complete guidance from the IRS has left open many issues. While an investment in a QOF Fund could provide the potential for a tremendous tax benefit, investors and fund sponsors should be aware of the following less frequently discussed issues related to QOFs:

1) Only investments of capital gain are currently eligible for the tax benefits, including the Exclusion Benefit. Prior to making an investment in a QOF an investor should confirm that she has available eligible capital gains to make the investment.

2) A deferral election must be made by the investor in the year the capital gains would have been recognized but for the investment in the QOF. Failure to make a timely election precludes the investor from obtaining any tax benefits from an investment in a QOF. As with many tax issues, a technical “foot fault” could exclude the availability of the tax benefits.

3) To obtain the full 15% Benefit on the deferred gain, under the current law and proposed regulations an investment in a QOF has to be made by the end of 2019. Investments made in 2020 and 2021 are only eligible for a 10% exclusion on the deferred gain, and investments made between 2022 and 2026 are eligible for deferral of the gain until 2026, but none of that gain will be excluded. Generally any investment of eligible capital gain in a QOF is still eligible for the Exclusion Benefit if it is held for more than 10 years even if it is not eligible for the 10% or 15% Benefit.

4) An investment in a QOF can create “phantom income.” If an investment in a QOF is held through December 31, 2026, the amount of the deferred gain (net of any 10% or 15% Benefit) will be automatically included in the investor’s 2026 tax return even if the investment in the QOF has not yet been sold. Investors therefore may recognize “phantom income” in 2026 – capital gain from the remaining deferred gain and no corresponding cash since the investment in the QOF has not yet been sold.

5) There are tax risks involved in an investment in a QOF. As mentioned above, on December 31, 2026, any remaining deferred gain will be recognized in income regardless of whether the investment in the QOF has been sold. If capital gain tax rates increase at the time of taxation, the deferral benefit may be minimized and /

or eliminated. For example, if $1,000,000 of gain is deferred and the QOF investment is held for at least 7 years and through December 31, 2026, the investor will recognize $850,000 of capital gain on December 31, 2026. Assuming the gain was long-term capital gain, and the effective tax rate is still 23.9%, the investor will owe a little over $203,000 in taxes. If in 2026 the preferential treatment for capital gains is eliminated and long-term capital gains are instead taxed at an ordinary rate (say 37%), the investor will instead owe $314,500 in taxes (37% of $850,000). If the investor did not defer the $1,000,000 in gain, she would have paid roughly only $239,000 in capital gains taxes in 2019. So there is a risk she will pay more in taxes by deferring, but if the property appreciates in value the savings from the Exclusion Benefit could outweigh the increase in taxes in 2026 due to a tax rate change. Of course if the capital gains tax rate goes down in 2026, the investor may have an additional benefit by deferring the gain.

6) It is uncertain what happens if a QOF sells a property. The Exclusion Benefit currently only applies when an interest in a QOF is sold after ten years, not when a QOF itself sells property after ten years. Under general tax rules, if the QOF sold the property after ten years it would recognize income on the sale. If the QOF is formed as a partnership and recognizes income, under general tax rules that income is allocated to the partners to report on their own tax returns. The IRS has not yet provided any guidance on whether the Exclusion Benefit would apply if the QOF sold property.

7) The IRS has not clarified whether or not a QOF formed as a partnership can still make debt-financed distributions. Generally partners can receive debt financed distributions from a partnership tax-free provided their adjusted tax basis in the partnership is higher than the distribution. The IRS has been asked to confirm that these rules still apply to a QOF.

8) Private equity and venture capital funds typically have fairly restrictive provisions in the agreements limiting or preventing the transfer of ownership interests by sale or otherwise. A QOF set up like a private equity or venture capital fund may have similar transfer restrictions. Since the Exclusion Benefit only applies to a sale of interests in a QOF, transfer restrictions may limit an investor's flexibility in determining when to sell the interests and take advantage of the Exclusion Benefit.

9) Entrepreneurs looking to start a business in an Opportunity Zone (e.g., a restaurant) should seriously consider setting up the ownership structure through a QOF in order to make the business attractive to a larger pool of investors should it seek capital investors.

10) Lastly, don't forget about the investment risk. Don't let the potential tax benefits overshadow proper due diligence in an investment.

If you need help understanding Opportunity Zones, or if you would like to discuss ways to establish or invest in a Qualified Opportunity Fund, please contact Russell J. Stein or Jay R. Peabody at Partridge Snow & Hahn LLP . They can be reached at 617-292-7900.

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