



## Client Advisory: Investments in Qualified Opportunity Funds

As part of the Tax Cuts and Jobs Act signed into law in December 2017, new Section 1400Z-2 was added to the Internal Revenue Code (the "Code") to encourage investments in low-income communities through "Qualified Opportunity Funds." On Friday, October 19, 2018, the Department of Treasury released initial Proposed Regulations, which answered some of the outstanding questions for investments in Qualified Opportunity Funds. We previously circulated a Client Advisory (available [here](#)) that included a copy of the Proposed Regulations. This Client Advisory (i) discusses the benefits and limitations to investors in Qualified Opportunity Funds, (ii) discusses the requirements for qualifying as a Qualified Opportunity Fund, and (iii) provides a hypothetical example showing an investment in a Qualified Opportunity Fund.

### What are the benefits of investing in Qualified Opportunity Funds?

For taxpayers with capital gain from the sale or exchange of property (in a transaction with an unrelated party), new Section 1400Z-2 provides three primary tax benefits:

1. Deferral of capital gain realized from the sale or exchange of property;
2. Exclusion of 10% of the deferred gain if the Qualified Opportunity Fund investment is held for 5 years and an additional exclusion of 5% of the deferred gain if held for 7 years; and
3. Exclusion of appreciation for investments in the Qualified Opportunity Fund if the investment is held for more than 10 years.

Importantly, and unlike Section 1031 of the Code, a taxpayer is only required to re-invest the amount of the capital gain in a Qualified Opportunity Fund. The taxpayer may use the remaining amount received from the sale of the property - typically an amount equal to the taxpayer's basis in the property - for any other purpose and still obtain deferral of all of the capital gain.

### What are some of the limitations for investors in Qualified Opportunity Funds?

1. 180-Day Period - In order to take advantage of the benefits of Section 1400Z-2, a taxpayer must invest in an equity interest in a Qualified Opportunity Fund within the 180-day period following the sale or exchange triggering the capital gain. The Proposed Regulations provided additional guidance and flexibility to partnerships and other pass-through entities by allowing either (i) the partnership or other pass-through entity to reinvest directly in a Qualified Opportunity Fund, or (ii) the partners or owners of the other pass-through entity to reinvest capital gain in Qualified Opportunity Funds.
2. "Phantom Income" on December 31, 2026 - If a taxpayer makes an investment in a Qualified Opportunity Fund and has not otherwise recognized gain from the investment, the taxpayer will be required to recognize all of the deferred gain - less the applicable 5-year and 7-year holding period exclusions described above - in the year ending December 31, 2026. Importantly, taxpayers will have to recognize this deferred gain even if the investment in the Qualified Opportunity Fund is still held by the taxpayer. In this case, a taxpayer will have what is commonly known as "phantom income" and would need to obtain funds from other sources to pay the tax due.
3. Capital Gain - A taxpayer may only take advantage of the rules under Section 1400Z-2 to the extent the taxpayer has capital gain. In other words, a taxpayer may not take advantage of these rules for sales or exchanges of property to the extent the sale or exchange triggers ordinary income (e.g., depreciation recapture).

### What are some of the requirements for being a Qualified Opportunity Fund?

1. Partnership or Corporation - A Qualified Opportunity Fund must be an investment vehicle that is organized as a domestic partnership or corporation for federal income tax purposes. The Proposed Regulations confirm that a Qualified Opportunity Fund can be organized as a limited liability company that is taxed as a partnership or corporation for federal income tax purposes, but a taxpayer may not take advantage of the rules under Section 1400Z-2 if the taxpayer invests directly in Qualified Opportunity Zone Property (including through a "disregarded entity").
2. Qualified Opportunity Funds - In order to qualify as a Qualified Opportunity Fund, at least 90% (the "90% Asset Test") of the Qualified Opportunity Fund's assets must be Qualified Opportunity Zone Property, which includes certain Qualified Opportunity Zones Business Property held directly by the Qualified Opportunity Fund or indirectly through qualifying subsidiaries. Very generally, Qualified Opportunity Zone Business Property is tangible property used in the business that is (i) located in the Qualified Opportunity Zone, (ii) purchased after December 31, 2017, and (iii) is originally used by the Qualified Opportunity Fund (or its qualified subsidiary) or is substantially improved by the Qualified Opportunity Fund (or its qualified subsidiary). Importantly, acquiring an existing building in a Qualified Opportunity Zone will not satisfy the above rules unless the building is

"substantially improved."

3. Related Party Transactions - If a Qualified Opportunity Fund purchases assets from certain related parties, these purchased assets will not count towards the 90% Asset Test. Therefore, taxpayers holding real estate in Qualified Opportunity Zones either directly or through an entity that is disregarded will need to work closely with their advisors to structure the transaction so the Qualified Opportunity Fund will satisfy the 90% Asset Test.

#### Example

Individual A holds publicly-traded stock (the "Stock") for investment purposes, which has a basis of \$1,000,000. On December 1, 2018, A sells the Stock in the stock market for \$10,000,000, which triggers \$9,000,000 of capital gain to A. A reinvests the \$9,000,000 of capital gain into an equity interest (the "QOF Interest") in a Qualified Opportunity Fund on January 31, 2019. Under Section 1400Z-2, A will initially have a zero basis in the QOF Interest. A continues to hold the QOF Interest until March 31, 2029, at which point A's sells the QOF Interest for \$20,000,000. The following results:

1. A is not required to recognize the \$9,000,000 of capital gain in 2018 and will continue to defer this gain until December 31, 2026;
2. On January 31, 2024 (i.e., 5 years after A acquires the QOF Interest), A's basis in the QOF Interest increases from \$0 to \$900,000;
3. On January 31, 2026 (i.e., 7 years after A acquires the QOF Interest), A's basis in the QOF Interest increases from \$900,000 to \$1,350,000;
4. On December 31, 2026, A is required to recognize capital gain of \$7,650,000 (i.e., \$9,000,000 minus \$1,350,000);
5. In addition, when A sells the QOF Interest on March 31, 2029 for \$20,000,000, A will not owe any additional federal income tax on the \$20,000,000.

As you can see from the above example, by holding the QOF Interest for more than 7 years, A has effectively eliminated 15% of the original \$9,000,000 capital gain triggered from the sale of the Stock. To fully benefit from these rules, the taxpayer must acquire the QOF Interest prior to December 31, 2019.

**If you have questions regarding the contents of this Client Advisory or investments in Qualified Opportunity Funds, please contact any member of our team.**



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