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Qualified Opportunity Funds

The latest way to do well by doing good

Impact investing—using wealth to create positive change in the world while also benefitting financially—has become increasingly popular, as the idea of "doing well by doing good" has gained traction among investors.

Now there's a new type of impact investment—called ***Qualified Opportunity Funds***—that is worth checking out if you're looking to build wealth, reduce a capital gains tax, and improve communities across the country. For investors with these goals, the funds can potentially be a powerful part of an overall wealth plan.

Sparking economic growth

Qualified Opportunity Funds invest in properties in economically distressed communities categorized as Qualified Opportunity Zones, which have been targeted for economic development.

These funds, which are generally formed as partnerships or corporations, can own a broad range of properties—from apartment buildings to start-up businesses—that exist in Qualified Opportunity Zones. By investing in these funds, you can help give communities a much-needed economic boost.

Big tax incentives

Let's say you have a taxable capital gain from the sale of appreciated property (including investment assets, art, real estate, a business and so on). If you reinvest that gain in a Qualified Opportunity Fund within 180 days of the sale, you can potentially receive some intriguing tax breaks. For example, you can:

- Defer capital gains taxes from the sale of the appreciated assets until December 31, 2026, or until the Opportunity Zone investment is sold (whichever comes first).
- Reduce the capital gains tax you pay by up to 15 percent because of an increase in the basis of the appreciated assets used to buy the fund interest.

Important: The basis increases by 10 percent if you hold your interest in the Qualified Opportunity Fund for a minimum of five years. Hold it for seven or more years, and the basis rises to 15 percent.

Bonus: You can eliminate the capital gains due on the appreciation in the Qualified Opportunity Fund if you hold the fund for ten years or longer.

There are some important timing issues here. If you still hold the Qualified Opportunity Fund on December 31, 2026, you will recognize the gain on the deferred amount (taking into account any increases in basis). Therefore, to receive the 10 percent increase in basis, you would have to invest in a Qualified Opportunity Fund by 2021. To get the extra 5 percent increase in basis, you would have to invest by the end of 2019.

BENEFITS OF QUALIFIED OPPORTUNITY FUNDS

The following hypothetical case studies help show the benefits that Qualified Opportunity Funds can potentially bring to different types of investors.

Case study 1: Business owner

Charles sells his business for a $12 million capital gain in June 2018. He locates three properties in two Opportunity Zones with a total purchase price of $12 million. Charles creates his own Qualified Opportunity Fund as a limited partnership fund, and his attorney ensures the partnership agreement contains appropriate language.

If Charles holds the Qualified Opportunity Fund until December 31, 2026, his tax bill the following April will be $570,000—$101,000 less than he would have paid in 2018.

That big reduction stems from the 10 percent basis bump after holding the fund for five years and an additional 5 percent basis bump for holding the fund for seven years.

Bonus: If Charles waits at least ten years to sell the three properties in the fund, any gain on those properties will escape taxes entirely.

In the end, Charles would get these benefits:

- Eight years of federal tax deferral
- A 15 percent reduction on the deferred gain
- Tax-free proceeds on the sale of the qualified Opportunity Zone property

Case study 2: Real estate investor

Tony, a real estate developer who has been working on gentrifying neighborhoods in the Northeast, sold two successful projects for a $20 million gain in 2018. He wants to take on bigger projects, but is reluctant to use bank financing.

Tony has a chance to buy two blocks of Qualified Opportunity Zone multifamily properties neighboring a major medical center. The purchase of the real estate and the development costs for the commercial project are beyond his means. Tony learns about the tax benefits of Qualified Opportunity Zones and commits his $20 million gain as initial capital for his Qualified Opportunity Fund.

Tony wants to use his Qualified Opportunity Fund as a vehicle to attract outside investors to his project, so his lawyers set up the fund as a partnership. Tony and his investors will receive the tax benefits of a Qualified Opportunity Fund on their investment. Tony will be able to attract investors on good terms and tackle a project that would otherwise be out of his reach. Ultimately, Tony gets both tax and business benefits by utilizing a Qualified Opportunity Fund.

Next steps

Each state nominates communities as Qualified Opportunity Zones. They can be found by going to www.cdfifund.gov/Pages/Opportunity-Zones.aspx. You can invest in any of these zones—you're not limited to zones that are near you.

To access Qualified Opportunity Funds, you have a few options. In general, interested investors tend to create their own funds and identify and buy the properties themselves—in part because this is a relatively new type of investment and there aren't that many commercial options from third-party providers yet. That may change, of course: If these funds catch fire with investors, we could see more providers enter the Qualified Opportunity Funds space with their own offerings.

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