Abstract: Anyone selling a business interest, real estate or other highly appreciated property could get hit with a substantial capital gains tax bill. One way to soften the blow — though it ties up the funds long term — is to “roll over” the gain into a qualified opportunity fund (QOF). This article explains how QOFs work and their potential benefits. A sidebar looks at recent IRS guidance on QOFs.

Rolling over capital gains into a qualified opportunity fund

If you’re selling a business interest, real estate or other highly appreciated property, you could get hit with a substantial capital gains tax bill. One way to soften the blow — if you’re willing to tie up the funds long term — is to “roll over” the gain into a qualified opportunity fund (QOF).

What is a QOF?

A QOF is an investment fund, organized as a corporation or partnership, designed to invest in one or more Qualified Opportunity Zones (QOZs). A QOZ is a distressed area that meets certain low-income criteria, as designated by the U.S. Treasury Department.

Currently, there are more than 9,000 QOZs in the United States and its territories. QOFs can be structured as multi-investor funds or as single-investor funds established by an individual or business. To qualify for tax benefits, at least 90% of a QOF’s funds must be “QOZ property,” which includes:

QOZ business property. This is tangible property that’s used by a trade or business within a QOZ and that meets certain other requirements.

QOZ stock or partnership interests. These are equity interests in corporations or partnerships, with substantially all their assets in QOZ property.

Note: Final regulations define “substantially all” to mean at least 70%.

What are the benefits?

If you recognize capital gain by selling or exchanging property, and reinvest an amount up to the amount of gain in a QOF within 180 days, you’ll enjoy several tax benefits.

Taxes will be deferred on the reinvested gain until the earlier of December 31, 2026, or the date you dispose of your QOF investment. There will be a permanent reduction of the taxability of your gain by 10% if you hold the QOF investment for at least five years, and an additional 5% if you hold it for at least seven years. If you hold it for at least 10 years, you’ll incur tax-free capital gains attributable to appreciation of the QOF investment itself.

The only way to obtain these benefits is to first sell or exchange a capital asset in a transaction that results in gain recognition. You then would reinvest some or all of the gain in a QOF. You can’t simply invest cash.

You or your heirs will eventually be liable for taxes on some or all of the original gain. Consider ways to avoid those taxes, such as holding the original property for life or doing a tax-free exchange.

Who can help?

The rules surrounding these QOFs are complex. We can help you further explore the idea.

Sidebar: IRS addresses QOFs in 2020 guidance

In February 2020, the IRS issued guidance on reporting gains from qualified opportunity funds (QOFs). It gives instructions on how to report the deferral of eligible gains from Section 1231 property and the inclusion of those gains when the QOF investment is sold or exchanged.

Taxpayers who defer eligible gains from such property, including gains from installment sales and like-kind exchanges, by investing in a QOF must report the deferral election on Form 8949, “Sales and Other Dispositions of Capital Assets,” in the deferral tax year. And taxpayers selling or exchanging a QOF investment must report the inclusion of the eligible gain on the form.