Advising Clients on Investing in Qualified Opportunity Zone Funds

By Robert Weins

The 2017 Tax Cuts and Jobs Act created one of the greatest tax-minimization opportunities since the 1981 Reagan cuts: qualified opportunity zone funds (OZ funds).[1]

OZ funds are designed to spur economic development and job creation by creating tax incentives to encourage investment in businesses located in economically distressed communities. In return, investors can receive tax deferrals and possible elimination of capital gains tax on their OZ fund investments.

This article is written for attorneys who are *not* tax specialists but want to provide insightful guidance regarding this valuable tax incentive. I provide a summary of the OZ fund tax benefits and identify factors your clients should consider when making an OZ fund investment. Let's get started with an example that demonstrates the three key tax incentives OZ funds offer.

Assume your client sold stock in 2020, generating capital gains of $100,000. If, within six months of selling this stock,[2] the client invests these capital gains into an OZ fund, he or she could receive the following tax benefits:

- **Tax deferral for capital gains invested in an OZ fund**: The client can defer paying taxes on the capital gains to the extent these gains are invested into an OZ fund. The taxes on the $100,000 stock gain will be deferred until the earlier of (1) December 31, 2026 or (2) the date on which the client sells the OZ fund investment.[3] That's a potential six-year tax deferral.

- **Reduction of tax on deferred gain for OZ fund investments held for five years**: If the client holds the OZ fund investment for at least five years, the taxpayer's deferred gain will be reduced by 10%.[4] In our example, this reduces the client's taxable deferred gain by $10,000 (i.e., $100,000 deferred gain × 10% = $10,000). It's worth noting the act includes a provision granting a 15% reduction in the deferred gain if the investment is held for seven or more years; however, for this provision to apply, the investment needed to have been made before 2020.[5]

- **Exclusion of gains for OZ fund investments held for 10 years or more**: If the client holds the OZ fund for 10 years or longer, he or she won't be taxed on any capital gains from the sale of the fund.[6] For example, if the client sells the fund in 2031 for $154,000, none of the gain would be taxable. It's important to note that OZ fund provisions are elective; if, at the time of sale, the client's fund basis exceeds its sales price, the OZ fund election should not be made so the loss can be recognized.

Let's look at a couple of detailed examples to see how this works.

Scenario one: Opportunity zone fund investment

Meet Ichabod and Griselda. They are a married couple who, in 2020, have ordinary income (e.g., wages and interest)

At a Glance

The 2017 Tax Cuts and Jobs Act allowed the creation of opportunity zone funds (OZ funds).

OZ funds are designed to spur economic development and job creation by creating tax incentives to encourage investment in businesses located in economically distressed communities.

OZ funds can be a valuable tool for enhancing after-tax returns of social impact investments.

of $300,000 and capital gains of $100,000 from the sale of stock. They have decided to invest this capital gain into an OZ fund which, to simplify our analysis, appreciates at a constant annual rate of 4%. Let's assume they hold their fund for 11 years, selling it in 2031 for approximately $154,000. Below are the tax benefits of this investment:

- **Temporary deferral of capital gains tax on sale of stock**: Ichabod and Griselda will defer paying taxes on their $100,000 stock gain until 2026. (Remember, the deferred capital gains taxes must be paid by the *earlier* of 2026 or the year they sell their OZ fund investment, 2031.) This tax deferral saves our investors $18,800 on their 2020 income taxes ($15,000 capital gain tax + $3,800 net investment income tax), allowing them to use these tax dollars to partially fund their OZ fund investment.
- **10% reduction in deferred capital gain**: As of December 31, 2026, our taxpayers will have held their OZ fund investment for more than five years. Hence, their deferred gain will be reduced by $10,000 (10% × $100,000 deferred gain).
- **Permanent exclusion of OZ fund gain in 2031**: As noted previously, at 4% annual growth, the OZ fund will appreciate to approximately $154,000; however, because Ichabod and Griselda held their fund investment for 11 years, none of this appreciation is taxable.

In summary, our investors receive a six-year deferral and a 10% reduction on their 2020 capital gain (i.e., 90% of the 2020 stock gain of $100,000 is taxed in 2026) and an exclusion of all capital gains taxes on the appreciated OZ fund investment.[7]

The 4% annual appreciation plus the tax benefits generate an after-tax return on investment of 4.8%. Sound good? Before deciding, let's look at another scenario.

Scenario two: Alternative investment

Ichabod and Griselda reinvest their 2020 capital gains in an investment that is *not* an OZ fund. Let's call this the "alternative investment." If this alternative investment also appreciates at 4%, their after-tax return on investment will be 3.2%. The OZ fund investment generates a better after-tax return because of three factors: (1) deferring the tax payment of the 2020 capital gain until 2026, (2) reducing the taxable portion of the deferred capital gain by 10%, and (3) excluding all capital gains taxes on the sale of the OZ fund.

The chart below details the tax calculations of these two scenarios.

INVESTMENT ASSUMPTIONS	
Opportunity Zone Fund Investment Year	2020
Investment Holding Period (years)	11
Opportunity Zone Fund Appreciation Rate	4.0%
Alternative Investment Appreciation Rate	4.0%

INVESTOR TAX ASSUMPTIONS	Year of Investment 2020	Year Investment is Sold 2031
Filing Status (select from drop-down list)	Married	
Ordinary Income	$300,000	$300,000
Capital Gains	$100,000	
Capital Gains Invested in Opportunity Zone Fund	($100,000)	NA
AGI Adjustment	($10,000)	($10,000)
Itemized Deductions	($20,000)	($20,000)

INVESTMENT RETURNS	Opportunity Zone Fund	Alternative Investment
Value of Investment in 11 Years	$153,945	$153,945

TAXES	Opportunity Zone Fund	Alternative Investment
Tax on Capital Gains NOT Invested in Opportunity Zone Fund (paid in 2020)		($18,800)
Tax on Deferred Capital Gains Invested in Opportunity Zone Fund (paid in 2026)	($15,980)	
Capital Gains Taxes on Opportunity Zone Fund or Alternative Investment	$0	($12,839)
Total Taxes Paid	($15,980)	($31,639)
After-Tax Return on Investment	$137,965	$122,306
Tax Saving from OZ Fund Investment	$15,659	
After-Tax Internal Rate of Return	4.8%	3.2%

Does this mean everyone should invest in OZ funds? No, for the following two reasons:

(1) It's unlikely that the OZ fund and alternative investment will appreciate at identical rates. Rather, it's probable you'll find alternative investments with greater appreciation potential. However, using the facts from our example, your alternative investment would need to appreciate at an annual rate of 5.9% to outperform an OZ fund with a 4% appreciation rate.

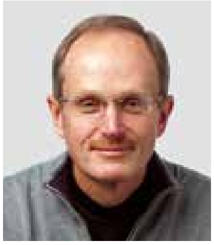
(2) The number of years you plan to hold the OZ fund and your tax bracket in the year of sale will significantly impact your after-tax returns. If your client plans to hold his or her investment for less than 10 years, an OZ fund investment is probably not a good fit.

Another non-tax factor you might want to discuss with a client considering an OZ fund investment is his or her interest in social impact returns. A growing number of investors are looking for more than economic returns—they seek investments that generate positive social outcomes. Because OZ funds are required to employ their capital in economically distressed areas,[8] they become a great vehicle for social impact investing. For example, a group of my clients is investing in early childhood education centers funded by OZ funds. These clients are using the fund tax benefits to enhance economic returns for a community-focused investment.

In summary:

- The 2017 Tax Cuts and Jobs Act allowed the creation of opportunity zone funds.
- OZ funds allow clients to defer (and potentially reduce) taxes on current capital gains *plus* reduce or eliminate capital gains tax from the subsequent sale of the investment.
- OZ funds can be a valuable tool for enhancing after-tax returns of social impact investments.

Because OZ funds are relatively new, their tax structure is not completely defined. New OZ fund investment opportunities are being created; however, they should be carefully vetted for tax compliance and economic viability. ■



Robert Weins, JD, CPA, is a member of Insights3, a consulting firm focused on helping organizations create and implement strategies that enhance profitability while generating positive community and environmental impacts. He has extensive experience in business startups, turnarounds, and private equity. He currently leads the MICPA Tax Task Force on OZ funds and works with foundations and mission investors to maximize financial and social impact returns. He can be reached at OZFunds@insights3.com with questions or ideas.

The author acknowledges the contributions of Marko Belej, a partner at Jaffe Raitt Heuer & Weiss, for his review and editing of the OZ Fund Investment Comparison Calculator. His insights and refinements were invaluable.

ENDNOTES

1. 26 USC 1400Z-2(d).
2. 26 USC 1400Z-2(a)(1)(A). The taxpayer must invest the capital gains in a qualified OZ fund within 180 days of the date of sale or exchange.
3. 26 USC 1400Z-2(b)(1).
4. 26 USC 1400Z-2(b)(2)(B)(iii). This is generally interpreted to allow investors to reduce the tax due on the deferred 2020 stock sale gain by 10% if the OZ fund investment is held for at least five years.
5. 26 USC 1400Z-2(b)(2)(B)(iv). This section allows taxpayers who hold their OZ fund investment for at least seven years to reduce the tax due on the deferred gain by 15%. However, 26 USC1400Z-2(b)(1)(B) requires the deferred gain be taxed no later than December 31, 2026. Hence, to qualify for the 15% tax reduction, only deferred gains invested before 2020 would be able to meet the seven-year holding period requirement.
6. 26 USC 1400Z-2(c).
7. *Id.*
8. 26 USC 1400Z-1(a) and 26 USC 1400Z-1(b).