Turn Capital Gains into Tax-Free Returns with Qualified Opportunity Funds

By Carol Wright, CPA

Earlier this month, Congress clarified new tax laws, providing investors with capital gains an extraordinary investment opportunity – one that could stir a nationwide development boom and deliver tax-free returns.

Legislative Recap

Last year's Tax Cuts and Jobs Act allowed investors to reinvest capital gains, like from the sale of stocks or other assets, in Qualified Opportunity Funds, which are entities dedicated to investing in mostly low-income areas throughout the country.

The funds must invest in eligible tracts of land selected by each state's governor called Qualified Opportunity Zones. In Michigan, as with other states, zone selection included input from local governments and economic development organizations.

Many of the Opportunity Zones are in low-income areas with room for growth, but there are also several in well-developed locations. For example, in Michigan there are zones in Troy, Midtown Detroit, and prominent stretches along the Detroit River in Downtown Detroit.

The benefits to Qualified Opportunity Fund investors are twofold. First, they can defer taxes on their reinvested capital gains until 2026. And second, if investors remain in the fund for 10 years or more, any gains they realize are tax-free.

If the program works as intended, it could spur long-term economic activity in areas where investment has been dormant, while also making investors quite happy with their net returns.

Who Can Benefit

From an investor perspective, three groups of people come to mind when thinking of who can benefit from these tax reforms.

One is those who have capital gains to realize, but would like to defer the taxes. The provisions to delay payment until 2026 and provide a 15 percent discount on the tax gain, are attractive. And obviously the possibility of a tax-free return appeals as well.

A second group of people is entrepreneurs who want to develop a business. Someone looking to run and grow a business in an Opportunity Zone could have an easier time attracting capital because of the tax benefits. Similarly, if they were to sell the business after 10 years, they would enjoy the same tax-free gain as investors.

Charitable-minded investors – those who want to do well by the world – could also benefit greatly by investing in a Qualified Opportunity Fund. Many of the eligible zones are in low-income areas that otherwise do not receive much investment. A flood of new assets could reinvigorate communities like never before.

How it Works

Let's say an investor has a large capital gain. Rather than realize the gain and pay taxes, she could invest that gain in a Qualified Opportunity Fund, which would then invest assets in a Qualified Opportunity Zone. For instance, the gains could be used to start a new business in one of the Opportunity Zones.

For a simple illustration, we'll assume the investor used $500,000 of her capital gains proceeds to invest in a Qualified Opportunity Fund, which then backed a new business in an Opportunity Zone. In 2026, she paid the capital gains taxes on the initial $500,000 gain. After a successful decade, the business is sold, and her share of the proceeds is $1.5 million, netting her $1 million. The $1 million capital gain would be tax-free.

To reinvest capital gains and take advantage of the tax incentives, first identify potential investments in Opportunity Zones, which are located throughout the country. Once an investment is identified, Rehmann recommends setting up a new entity, like a Limited Liability Company

(LLC), dedicated only to the Opportunity Zone investment.

This new LLC is the Qualified Opportunity Fund through which investment flows and tax benefits are realized. The law specifies the fund must be set up with the purpose of investing in a Qualified Opportunity Zone, which is why a new entity often makes the most sense. However, the regulations permit an exsisting entity to qualify as well.

After the Qualified Opportunity Fund is established, investors have six months from the time they realize their capital gains to reinvest them in the fund. From there, the fund has six months to invest 90 percent or more of its assets in qualified business property, like new equipment or a building. If the fund's qualified property includes a new building or renovations to an existing building, the work must take place within 30 months to comply with the regulations. An existing building qualifies if improvements equal to the original cost are made.

The timelines are quick by design. With this structure, Opportunity Zone work will move from seed funding to "open for business" quickly. As such, investors need to be ready to go with these projects to reap the tax benefits.

In the earlier example, the business was sold in 10 years. But what happens if investors sell before 10 years? The regulations account for that:

- Investors can defer their original tax bill until December 31, 2026 at the latest, or until they sell their Opportunity Fund investments, if earlier.
- A 5-year holding increases the rolled-over capital gains basis by 10 percent, decreasing the amount of the original gain recognized.
- A 7-year holding increases the rolled-over capital gain investment basis 5 percent, to 15 percent total.

After 10 years, the gain is permanently excluded from taxes as long as the investment is sold by 2047.

Opportunity in Action

The most compelling way to see the potential of this legislation is through real-world situations. The following examples are from clients and illustrate a small sampling of the opportunities available through Qualified Opportunity Funds.

Historic Building Conversion

A client with an option on a historic downtown commercial property had capital gains from the sale of other assets. The client knew other people with capital gains, so they combined their gains into a new Qualified Opportunity Fund and purchased the property.

Soon after, they used the fund assets to break ground on a mixed-use building that will combine residential and commercial tenants in an up-and-coming part of town. Their plan is to own the property for at least 10 years, and the group projects a minimum 50 percent return on its long-term investment, all of which would be free of taxes.

Entering an Emerging Market

Qualified Opportunity Funds also can be used to expand into new markets. A client who manufactures equipment used in fitness facilities identified an opportunity to sell the same products (with minor tweaks) to corporate offices.

Instead of starting a "corporate" division, the client is looking to form a new company dedicated to the corporate market. The new business will be capitalized through a Qualified Opportunity Fund and located in an Opportunity Zone near the existing company.

At minimum, taxes due on the gain that capitalized the company will be deferred until 2026. But fast forward 10 years and imagine the business does well. If it's sold based on skyrocketing revenue, the gain will be entirely tax-free.

West Coast Expansion

A client who owns surgery centers identified California as an ideal expansion market. We worked to find potential locations within Opportunity Zones in California that could fit into the larger expansion plan.

Those new locations were lumped into a Qualified Opportunity Fund and used to attract further qualified investment. The investors in the fund holding the Opportunity Zone locations will receive the original gain deferral, and a tax-free gain if the locations are sold after 10 years.

Getting Help

Past government incentives with decades-long benefit periods have not been nearly as impactful as the new Qualified Opportunity Fund legislation. And while the examples above are helpful to showcase the regulations' potential, they are simplified. In practice, taking advantage of Qualified Opportunity Fund benefits is highly complicated, especially since the laws are still unfolding.

If you are interested in investing in an Opportunity Zone or would like to learn more, Rehmann offers tax and business planning services to help investors evaluate opportunities. To get started, please call Carol Wright, CPA, at 866.799.9580.