Qualified Opportunity Funds: Parallels and Opportunities for Qualified Small Business Stock Investors

by Christopher A. Karachale

The Tax Cuts and Jobs Act ("TCJA") provides new exclusion and deferral benefits for investors who purchase interests in qualified opportunity funds. Much like qualified small business stock ("QSBS") under IRC sections 1202 and 1045, new IRC section 1400Z-2 allows investors to defer and, in some cases, exclude gain on the sale of assets. However, gain can be deferred under IRC section 1400Z-2 only if invested in designated low-income communities.

But, IRC section 1400Z-2 is more generous than QSBS. Unlike QSBS, qualified opportunity funds don't require that the original stock be QSBS or any other specific stock. Under IRC section 1400Z-2, the gain from the sale of *any* stock or other assets can be deferred and potentially excluded from income.

Qualified Opportunity Fund Deferral and Exclusion

Where a taxpayer sells stock or other assets, and reinvests in a qualified opportunity fund within 180 days, the taxpayer can defer all gain on such sale. The original gain is not taxed until the time the taxpayer disposes of her interest in the qualified opportunity fund. In addition, provided the taxpayer holds the qualified opportunity fund for five years, the taxpayer's original basis is increased by 10 percent (reducing the taxable gain). Where the taxpayer holds the qualified opportunity fund for seven years, the original basis is increased by another 5 percent (again reducing the taxable gain by a total of 15 percent). Finally, where a taxpayer holds an interest in a qualified opportunity fund for 10 years, 100 percent of the original gain is excluded. In effect, investors who reinvest gain in qualified opportunity funds can be assured deferral of such gain and an incremental increase in potential exclusion from gain.

Qualified Opportunity Fund Requirements

A qualified opportunity fund can be formed as either a corporation or a partnership. The qualified opportunity fund must hold at least 90 percent of its assets in "qualified opportunity zone property" located in certain IRS designated low-income community population census tracts known as qualified opportunity zones. Qualified opportunity zone property includes both direct investment in assets used in a qualified opportunity zone as well as investment in businesses where substantially all the assets of the business are used in a qualified opportunity zone. In short, 90 percent of a qualified opportunity fund's assets must be located and used in an IRS designated qualified opportunity zone.

On July 9, 2018, the IRS published Notice 2018-48 containing the official list of all census tracts designated as qualified opportunity zones. In California, the IRS designated more than 850 census tracts as qualified opportunity zones. San Francisco alone has 11 qualified opportunity zones located in the Bayview–Hunters Point area generally as well as on Treasure Island.

New Options with Qualified Opportunity Funds

IRC section 1400Z-2 provides important opportunities for QSBS investors, especially those who may fail the deferral or exclusion provisions of IRC sections 1045 and 1202.

Assume that founder Frank creates a qualified small business that meets the requirements of IRC section 1202 and, in year three, sells his QSBS for $10 million. Typically, Frank would reinvest those proceeds within 60 days in another qualified small business and defer gain under IRC section 1045. After five years, Frank can sell the second qualified small business and exclude the gain under IRC section 1202.

But what if Frank fails to find a second qualified small business for reinvestment within 60 days? Previously Frank had no other option but to pay tax on the gain from the sale of the first qualified trade or business. With an investment in a qualified opportunity fund, Frank now has a second bite at the deferral apple. Under IRC section 1400Z-2, Frank has 180 days after the sale of the first qualified business to invest the gain in a qualified opportunity fund. Of course, Frank now needs to hold his investment in the qualified opportunity fund for 10 years to exclude the original gain (rather than just two years had he found a second qualified small business). But, with the advent of qualified opportunity funds, Frank now has another deferral option, even if he fails to meet the 60 day reinvestment requirement under IRC section 1045.

In addition, assume that after Frank sells his stock in the first company, he realizes that it was not a qualified small business under IRC 1202. Previously, Frank would have no deferral options; the shares would be treated just like any other stock and subject to tax at long-term capital gains rates. However, with qualified opportunity funds, Frank still has the potential to defer gain. Unlike QSBS, IRC section 1400Z-2 has no threshold requirement to defer gain. Gain from the sale of any stock – QSBS or not – can be deferred. So even if Frank determines that his shares of the first company are not QSBS, he can still defer the gain on those shares if he invests in a qualified opportunity zone within 180 days.

Taxpayers with questions about qualified small business stock or qualified investment funds are encouraged to contact Christopher Karachale or the Hanson Bridgett Tax Practice Group.

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