A DOZEN WAYS TO ENHANCE TAX-EFFICIENT FINANCIAL PLANS WITH QUALIFIED OPPORTUNITY FUNDS

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This article discusses a dozen ways to enhance tax-efficient financial plans with Qualified Opportunity Funds

Introduction to Qualified Opportunity Funds

Many taxpayers and even some financial advisors are not aware of the numerous ways they can be used to create tax-efficient financial results. Investors can defer tax payments on prior capital gains if they re-invest the gains in real estate or business development in economically distressed areas known as "Opportunity Zones."

To help mitigate economic disparity, Congress created Qualified Opportunity Funds (QOFs) as part of the Tax Cuts and Jobs Act (TCJA) of 2017. The TCJA narrowed the use of Section 1031 exchanges, but by creating QOFs it greatly broadened the types of capital gains eligible for tax incentives. Now a capital gain from selling a stock, a business, or just about anything else you can think of, creates the opportunity to enjoy significant tax incentives.

A group of bipartisan Senators and Representatives are expected to reintroduce The Opportunity Zones Transparency, Extension, and Improvement Act. The legislation is expected to enhance the community impact reporting requirements for QOFs and extend and enhance the potential tax incentives for current and future QOF investors. If enacted, this legislation would be the first substantial update to the Opportunity Zone statute since it was enacted in 2017.

To qualify for the QOF tax incentive, investors must reinvest a capital gain into a QOF within 180 days of realizing the gain. QOFs, in turn, reinvest the capital into any of the more than 8,700 designated low-income Opportunity Zones nationally, designed to spur economic development and job creation in distressed communities. Investors earn tax advantages and benefits by investing in new construction or making "substantial improvements" to an existing property within 30 months.

Opportunity Zones themselves are defined by census tracts typically with populations of two to eight thousand people and highly variable economic potential. (Certain types of business cannot be included in QOFs, even if they reside within Opportunity Zones, such as golf courses, country clubs, liquor stores, and racetracks or other facilities used for gambling.)

QOF tax incentives are generous and well worth pursuing. Pundits often cite an after-tax advantage of 3% based on a market return of

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7% to 8% and a 10-year holding period. The math works out to an extra 40% return (3%/7.5%=40%) to investors, not just one time but year after year. Tax-free compound growth is a wonderful thing!

The following are the tax incentives of QOFs:

- The original capital gain is deferred until the end of 2026 or the date the QOF is sold, whichever comes first. (Note that legislation, with bipartisan and bicameral sponsorship, is expected to be reintroduced before the end of 2023 that would extend Qualified Opportunity Fund tax incentives. The QOF deferral benefit period will likely be extended from 2026 to 2028 or 2029. In addition, the bill will likely bring back the currently expired 5% and 10% tax elimination incentives on the original investment.)
- After holding the QOF for 10 years, any capital gain in the QOF investment can be eliminated via a 100% cost basis step-up option. This benefit does not expire until 2047, so investors can enjoy decades of tax-free compound growth.

QOFs are still relatively new and often overlooked but increasingly, financial professionals are using them to create uniquely tax-efficient strategies. Some of the strategies below require that the investor control their holding period. There are QOFs that offer the liquidity of tradable shares, but they need to be sought out. The first generation of QOFs had fixed holding periods, normally 10 years, and this is still the case for the overwhelming majority of QOFs.

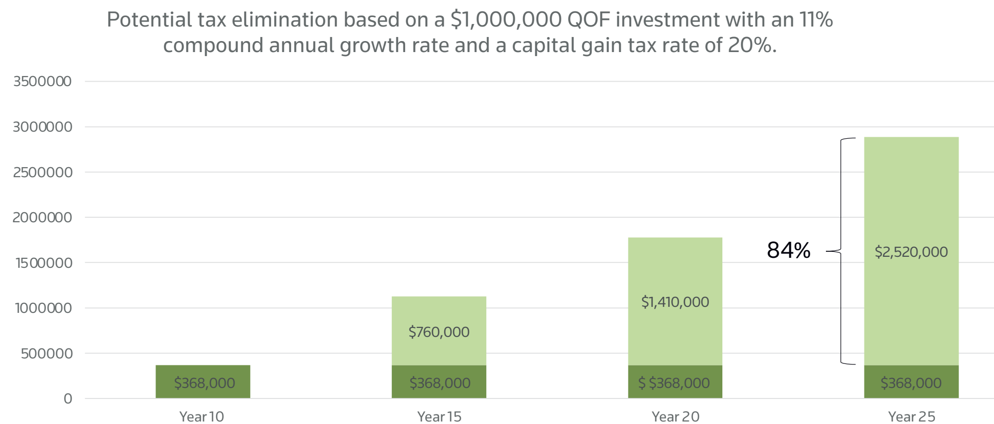
A dozen ways to enhance tax-efficient financial plans with QOFs

The following are 12 ways to use QOFs to enhance tax-efficient financial plans:

1. *Art/collectibles.* Taxpayers with capital gains in collectible assets, such as art, precious metals (even exchange-traded funds (ETFs) invested in collectibles such as gold ETFs), wine, etc., should be particularly motivated to utilize QOF tax-incentives. The same legislation that created QOFs eliminated the eligibility of collectibles to claim Section 1031 (like-kind exchange) tax treatment. Before the Tax Cuts and Jobs Act, a collector could sell an appreciated asset and defer the tax by executing a 1031 exchange into a new like-kind asset. Now when a collector has a capital gain, they cannot defer the tax through a "like-kind exchange," and they also face a higher marginal capital gain tax rate of 28% versus 20% for most asset classes. They can, however, defer the tax through a QOF investment.
2. *Making cash QOF eligible.* For a taxpayer to claim QOF benefits, they have to reinvest an amount equal to or less than capital gains they have taken in the last 180 days. Fortunately, unlike 1031 exchanges, QOF investments do not need to invest the same funds received from the capital gain – there is no cash tracing requirement, and this can be very helpful for an investor with liquidity. If an investor would like to benefit from QOF tax incentives but currently only has cash that is not eligible, they could trigger a gain elsewhere in their portfolio. For example, an investor could sell a stock with a low-cost basis and buy it back immediately. Their money will now be eligible for a QOF tax incentive for the next 180 days - up to the amount of the triggered capital gain. Additionally, they will have eliminated the unrealized capital gain liability from their stock position. This transaction would not be subject to wash sale rules because those apply to harvesting tax losses, not gains.
3. *Long-term wealth creation.* The biggest tax benefit offered by a QOF investment is the potential for tax-free compound growth. Once an investor achieves a 10-year hold in the QOF they can elect to step-up their cost basis 100%, eliminating any capital gain liability. This benefit is often thought of as a 10-year benefit, but that is just the beginning because the benefit does not expire until 2047 – another 24 years. Compound growth curves accelerate in the outer years, and this is certainly true for QOFs. Using typical market returns, roughly 84% of tax benefits are derived after year 10. Unfortunately, many QOFs have planned liquidations shortly after the 10th year, ending the tax-free compound growth prematurely. Make sure your QOF has a perpetual life to maximize this benefit. If you are lucky enough not to have to withdraw from your investment, then the option to keep this powerful wealth creating tax incentive rolling can be very beneficial.
4. *Boot.* In a Section 1031 exchange, the entire proceeds of a sale must be invested into a new property to defer the whole tax liability. When a property is exchanged into a lower priced property, the difference is taxable and referred to by 1031 practitioners as "boot". Finding 1031 eligible investments with smaller remainder amounts can be difficult, especially if the boot is less than $100,000. Publicly traded

EXHIBIT 1
Amount of Tax Liability That Can Be Eliminated Through a QOF Investment.

This graph illustrates the amount of tax liability that can be eliminated through a QOF investment held for various holding periods. Most funds will miss out on the majority of potential tax savings because they plan to liquidate after achieving a 10-year hold. QOF tax-free growth expires in 2047.



QOFs can accommodate investors with just the purchase of one share of stock. For investors hoping to defer tax liabilities on boot, QOFs may be the only practical choice.

5. Rescuing a failed 1031 exchange. The rules for executing a successful 1031 exchange are rigid. Investors cannot take possession of the sale proceeds, so typically, an intermediary is hired to keep the cash segregated. The investor has 45 days to identify the properties they will be exchanging into. It is not unusual for a 1031 seller to receive the sale proceeds into their own bank account or to have difficulty finding a new property in such a short window, either of which would make them ineligible for 1031 tax deferral benefits. Luckily, neither of these restrictions apply to QOF investments. This means QOFs are frequently called upon to "save" failed 1031 exchanges.
6. *Liquidity for high tax basis 1031 investors.* 1031 exchanges have been a tried-and-true financial planning tool for decades and they are still a great choice in many circumstances. However, there are also many situations where investing in a QOF can be the right choice. This is especially true for investors selling a high-cost basis property, particularly if they would like to have less of their assets encumbered. As an example, if the investor sold a property for 10 million dollars and their tax basis is nine million, to defer the one-million-dollar capital gain, a 1031 exchange would require the entire 10 million dollars in proceeds to be reinvested while a QOF investment would require only one million dollars of capital gain be reinvested to defer the entire capital gain liability. Investors using the QOF would be free to use the nine million in principal as they wish.
7. *Alleviating asset concentration risk for 1031 investors.* 1031 investments are a powerful tax deferral tool, but because they require the entire sale proceeds be reinvested in "like-kind assets," asset concentration can build up in portfolios over decades. 1031 investors, especially as they approach retirement, often find they have portfolios with poor diversification and high leverage. Investors can avoid this situation by using a QOF, which only requires the capital gain portion of a sale to be reinvested to maximize tax incentives. This frees the investor to allocate the principal portion of their proceeds to asset diversification, debt reduction, vacations, or in any other way they choose.
8. *Section 1231 capital gain or ordinary income.* Gains and losses from business property (1231 gains) are taxed asymmetrically; gains are taxed at capital gains rates, but losses are taken at ordinary income rates. This is an advanta-

geous rule, but there is a "five-year look back period." If you took a loss four years ago and this year you have a 1231 gain, the tax rate for the gain will be at ordinary income tax rates to offset the loss within the "look back" window. A qualifying QOF investment can defer the gains realization date beyond the "five-year look back," thus reducing the tax rate.

9. *Defer gains to offset potential future loses.* QOFs can provide investors participating in volatile sectors with a great option for mitigating taxes. When an investor has a capital gain, whether short term or long term, they can choose to pay the tax, or they may want to defer the tax by using QOF tax incentives. If they defer the gain and then suffer a loss in any future year during the deferral period, they can trigger all or a portion of their deferred gain by selling the appropriate portion of their QOF. This realization of a deferred tax liability, in a year with a tax loss, delivers tax efficiency while keeping capital working for you longer.
10. *Relief from investor accreditation requirements.* Most of the investing public would not qualify as accredited investors. Even if you are accredited, you may not want to go through the potentially invasive financial disclosures to prove it. Fortunately, there are publicly traded QOFs you can buy and sell without the accreditation requirement. Public trading is not offered by most QOFs because it requires the QOF to navigate a significantly more robust and lengthy Securities and Exchange Commission vetting process.
11. *Eliminating K-1 tax forms.* K-1 tax forms are notoriously difficult, and the information needed to file them in a timely fashion often becomes available to investors late, forcing them to file a tax extension. To make matters worse, in diversified funds the owner can receive separate K-1s for each state in which the fund owes tax plus their home state. K-1 forms are distributed to owners through pass-through entities, which is how all QOFs are set up because the structure maximizes tax efficiency. There is one type of pass-through entity that does not issue K-1 tax forms, a real estate investment trust (REIT). A REIT is a corporation that is taxed like a partnership. Their corporate status means that shareholders receive a single, easier, and more familiar 1099-DIV form. This greatly simplifies a QOF investor's tax filings. While most QOFs are partnerships, some QOF REITs are also available.
12. *Socially responsible investing—saving the best for last.* The idea behind the very generous QOF tax incentives is to drive capital into low-income neighborhoods to energize their local economies. Qualifying investments must bring new capital into the community such as ground-up construction or an investment in the substantial improvement of an aging property. A QOF cannot simply buy an existing building in a designated Opportunity Zone, for instance. QOFs are creating jobs and driving economic activity in the areas that need it most, addressing one of the biggest problems facing the United States today, economic disparity.

As always, these strategies only work if the underlying fund performs, so it is crucial to understand a fund's strategy, management, and fees.

Conclusion

Given the significant tax savings they can deliver and the many ways they can be utilized, QOFs are likely to continue to gain prominence as a financial planning tool every investor and advisor should examine when designing a tax-efficient financial strategy.

Please keep in mind the following:

- Not all QOFs offer the liquidity needed for some of the strategies discussed in this article.
- This article discusses potential federal tax benefits, but most states offer benefits to QOF investors as well.
- Legislation is expected to be reintroduced in Congress that would extend QOF tax incentives. This bill is considered to have a good chance of being passed, but the final form of the legislation and the timing of enactment are impossible to determine at this time. Current QOF investors are expected to participate in the benefits of this potential extension. ■