Steven M. Vogt, CPA, EA

Defer Gains with Qualified Opportunity Funds

If you have a large capital gain from the sale of a stock, asset, or business and would like to defer that gain with the possibility of excluding some of it from taxation, you may want to check out the new investment vehicle created by tax reform, called a qualified opportunity fund (QOF).

Congress, as a means of helping communities that have not recovered from the past decade's economic downturn, included a provision in the Tax Cuts and Jobs Act intended to promote investments in certain economically distressed communities through QOFs. Investments in QOFs provide unique tax incentives that lawmakers designed to encourage taxpayers to participate in these funds.

Reinvesting Gains – Taxpayers who have a capital gain from selling or exchanging any non-QOF property to an unrelated party may elect to defer that gain if it is reinvested in a QOF within 180 days of the sale or exchange. Only one election may be made with respect to a given sale or exchange. If the taxpayer reinvests less than the full amount of the gain in the QOF, the remainder is taxable in the sale year, as usual. Only the gain need be reinvested in a QOF, not the entire proceeds from the sale. This is in sharp contrast to a 1031 exchange where the entire proceeds must be reinvested to defer the gain.

The gain income is deferred until the date when the QOF investment is sold or December 31, 2026, whichever is earlier. At that time, the taxpayer includes the lesser of the following amounts as taxable income:

a. The deferred gain or
b. The fair market value of the investment, as determined at the end of the deferral period, reduced by the taxpayer's basis in the property. (Basis is explained below.)

A taxpayer who holds a QOF investment for 10 years or more before selling it can elect to permanently exclude the gain from the sale that is in excess of the originally deferred gain (i.e., the appreciation).

Qualified Opportunity Fund Basis – The basis of a QOF that is purchased with a deferred gain is $0 unless either of the following increases applies:

(a) If the investment is held for 5 years, the QOF's basis increases from $0 to 10% of the deferred gain.

(b) If the investment is held for 7 years, the QOF's basis increases from $0 to 15% of the deferred gain.

If, on December 31, 2026, a taxpayer holds a QOF that was purchased with deferred gains, the original deferred gain, or if less, the difference between the fair market value of the QOF reduced by the basis, must be included as gross income on that taxpayer's 2026 return; the basis of the investment will then be increased by the amount of this included gain.

If the QOF investment is held for at least 10 years before being sold, the taxpayer can elect to increase the basis to the property's fair market value. This adjustment means that the QOF's appreciation is not taxable when it is sold.

Example 1: On June 30, 2018, Phil sold a rental apartment building for $3 million, resulting in a gain of $1 million. Within the statutory 180-day window, he invested that $1 million into a QOF and elected to defer the gain from the building's sale. On July 1, 2026, he then sold the QOF for $1.5 million. Because Phil held the investment for over 7 years, its basis is enhanced by $150,000 (15% of $1 million). Because the investment's fair market value is greater than the original deferred gain, he must include a taxable gain of $1.35 million ($1.5 million – $150,000) in his 2026 *gross income.*

Example 2: The facts here are the same as in Example 1, except Phil waited to sell the QOF until 2030, meaning that he held it for nearly 12 years. On December 31, 2026, the fair market value of the QOF was $1 million. Because he had the investment on December 31, 2026, he was required to include $850,000 ($1 million – $150,000) of deferred gain on his 2026 return, the lesser of the $1 million gain he'd deferred or the FMV less his basis. He then increases his basis in the QOF from $0 to $850,000. After selling the QOF for $1.5 million in 2030, Phil elected to permanently exclude the gain by increasing his basis to $1.5 million (the fair market value on the date of the sale). Thus, he has no gain ($1.5 million – $1.5 million) in 2030.

Mixed Investments – If a taxpayer's investment in a QOF consists of both deferred gains and additional investment funds, it is treated as two investments; this provides the tax benefits of both types: the temporary gain deferral and the permanent gain exclusion (which applies only to the deferred gain).

Qualified Opportunity Funds – To defer capital gains-related taxes through the recently enacted opportunity-zone program, taxpayers must invest in a QOF – an investment vehicle that is organized as a corporation or a partnership for the purpose of investing in properties within qualified opportunity zones. These investments cannot be in another QOF, and the properties must have been acquired after December 31, 2017. The fund must hold at least 90% of its assets in the qualified-opportunity-zone property, as determined by averaging the percentage held in the fund on the last days of the two 6-month periods of the fund's tax year. Taxpayers may not invest directly in qualified opportunity zone property.

Partnerships – Because a QOF that is purchased with deferred capital gains has a basis of zero, taxpayers who invest in QOFs that are organized as partnerships may be limited to deducting the losses that these partnerships generate.

Qualified Opportunity Zones – A low-income census tract can be specifically designated as a qualified opportunity zone after a nomination from the governor of that community's state or territory. Once the qualified opportunity zone nomination is received in writing, the U.S. Treasury Secretary can certify the community as a qualified opportunity zone. Once certified, zones retain this designation for 10 years.

If you have a capital gain or potential gain and would like to explore the tax ramifications for your particular situation of deferring the gain into a QOF, please give this office a call.

Chandler Office • 1807 E. Queen Creek Road, Suite 5 • Chandler , Arizona • 85286 • (480) 732-9898