

An introduction to Qualified Opportunity Zones

Learn about a new way to cut taxes by investing in economically distressed areas.

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Key takeaways

The Qualified Opportunity Zone program offers taxpayers a potential federal capital gains tax incentive for investing in economically distressed areas of the US.

The potential tax benefits include deferral, discount, and exemption from federal capital gains taxes.

Given that it is a new program with complex rules, investors should work with their legal, tax, and financial advisors to perform proper due diligence on these investments and understand their potential benefits and risks.

Sweeping revisions to the federal tax landscape were made with the 2017 Tax Cuts and Jobs Act. Among the changes was the establishment of the Qualified Opportunity Zone (QOZ) program, which offers taxpayers a potential federal capital gains tax incentive for committing to long-term investments in economically distressed areas.² Specifically, taxpayers may be able to defer and potentially reduce recognized capital gains by investing in a Qualified Opportunity Fund (QOF) created under this program. The purpose of the program is to spur economic development and job creation in these economically distressed areas.

QOFs are inherently speculative and individuals should work with their legal, tax, and financial advisors to perform due diligence on these investments and understand their potential benefits and risks. QOFs have the potential to decline in value. Losses could erode or entirely negate any tax benefits, or cause the value to fall below the taxpayer's original investment in the QOF.

What is a Qualified Opportunity Zone?

A QOZ is an economically distressed area that was nominated by the individual states and certified by the IRS. A list of QOZs is available on the US Department of

Treasury's website.³

What is a Qualified Opportunity Fund (QOF)?

A QOF is an investment vehicle in the form of a domestic corporation or domestic partnership that invests in property within a QOZ.⁴ A QOF can invest directly by holding business property in a QOZ or indirectly by holding stock or an ownership interest in certain businesses located in a QOZ.

The potential tax benefits of QOFs

There are three possible income tax incentives for taxpayers interested in investing in a QOF: deferral, discount, and exemption. First, a taxpayer may defer recognizing capital gains from a sale of a capital asset if the capital gains are invested in a QOF within 180 days of the disposition of the property. By investing in a QOF, a taxpayer is able to defer recognition of their capital gains until either the QOF is sold, or December 31, 2026, whichever occurs first. A taxpayer may invest an amount greater than the eligible gain, but only the capital gain portion will be eligible for the tax benefits under the program.

Example 1

Tiffany liquidates her portfolio in April 2020 and generates a \$5 million long-term capital gain. She invests only the \$5 million capital gain into a QOF in December 2020 (Notice 2020-39 extension). By investing in a QOF within 180 days, Tiffany may defer \$1.19 million of capital gains tax (\$5 million x 23.8%) that would have been payable on her 2020 income tax return.^{5,6}

Next, a taxpayer may receive a potential discount upon recognition of the capital gains that were initially invested in the program. In general, depending on the timing of a taxpayer's investment and the period the investment is held, up to 10% of the taxpayer's rolled gain may be permanently exempt from taxation. Specifically, the cost basis of a QOF should increase by 10% after 5 years.

Example 2

At the time of the initial investment in December of 2020, Tiffany's cost basis in the QOF is considered to be zero, even though she contributed \$5 million.

In 2025, Tiffany's cost basis in the QOF should increase from zero to \$500,000 (which is a 10% increase, calculated based on the original \$5 million contribution amount) because she would have held the QOF for 5 years.

In 2026, Tiffany may then recognize only \$4.5 million in capital gains instead of the \$5 million that she would have recognized in 2020 had she not invested in the QOF; thus saving approximately 10%, or \$119,000, in capital gains taxes.⁷

Finally, a taxpayer may be able to permanently exclude any appreciation on the original capital gains investment in the QOF if the funds remain in the QOF for at least 10 years.

Example 3

By 2030, Tiffany's interest in the QOF has increased from \$5 million to \$10 million. Tiffany decides to exit the QOF and liquidates her entire position. Tiffany already reported her capital gains on her initial \$5 million QOF investment on the mandatory recognition date of December 31, 2026 and paid the related tax by April 15, 2027, using assets outside the QOF. The remaining \$5 million should not be subject to capital gains tax since Tiffany was invested in the QOF for at least 10 years.

Potential risks of QOFs

There is no guarantee that an investment in a QOF will yield a profit, and it may lose money. If a QOF declines in value, a taxpayer runs the risk that the overall loss in a QOF may be greater than the discount on the initially invested capital gain. Since QOFs are long-term strategies, QOF investors may not have the option to sell to mitigate potential losses. For example, there may be no market to sell the QOF, or a sale would be considered an "inclusion event," which would cause a QOF investor to recognize some or all of its deferred capital gains⁵.

Example 4

The QOF declines in value during Tiffany's 5 year holding period by 25%, which causes a drop in value of Tiffany's interest from \$5 million to \$3.75 million. Tiffany's capital gains tax liability at the end of the holding period should still be calculated on her original \$5 million investment and not the current value of the fund. This will be calculated using the 10% cost basis step-up, which reduces the capital gain from \$5 million to \$4.5 million, but that gain still exceeds the \$3.75 million current value of her QOF investment. Had Tiffany recognized her \$5 million capital gain initially, rather than invest it in the QOF, she might have considered more conservative investment options that may have allowed her to mitigate potential losses in value

Estate planning with QOFs

If a QOF is gifted to a charity or an individual other than the taxpayer's spouse, this gift would be considered an inclusion event and may trigger the inclusion of the deferred capital gains in the taxpayer's taxable income in the year the gift is made. If a QOF is gifted, sold, or swapped to a grantor trust or distributed to a taxpayer's beneficiaries upon death, it should not be considered an inclusion event. (For more information on grantor trusts, please see *Trusts and Taxes: Exploring the Federal Income Tax Implications of Trust Strategies*.)

Further, if a QOF is gifted to a grantor trust or distributed upon death prior to December 31, 2026, there will be no step-up in cost basis in the QOF. Although there is no step-up in cost basis, the taxpayer's holding period in the QOF will tack on or carry over to the beneficiary of the QOF. However, this may present an income tax issue for the beneficiary if the beneficiary does not hold sufficient liquid assets to cover the impending deferred capital gains tax liability associated with the QOF.

Example 5

In April 2020, Tiffany's cost basis in the QOF is considered to be zero even though she contributed \$5 million. In 2021, Tiffany dies and leaves her interest in the QOF to Diana, her 25-year-old daughter.

If Diana holds on to the interest in the QOF, by 2026 her cost basis should have increased to \$500,000 and she will recognize \$4.5 million in capital gains (instead of the \$5 million her mother rolled). But this could still result in a significant federal capital gains tax liability for Diana of \$1,071,000. (The amount owed would, of course, depend on Diana's other income and realized capital gains that year). It's possible Diana may not have sufficient assets to pay the associated income tax liability.

In example 5, Tiffany made a generous bequest to her daughter, but one that included deferred tax liability. If indeed Diana does not have sufficient funds to cover the income tax liability, she may attempt to liquidate the QOF to pay the taxes. This could be problematic if the QOF performed poorly during the holding period and is worth significantly less than the initial investment. Even if the QOF increased in value during the holding period, it is unlikely that Diana could receive fair market value for the investment. In fact, depending on the circumstances, she may only receive pennies on the dollar for the QOF, since the market for QOFs may not be liquid; and even if it were, a buyer would not be able to benefit from the deferral incentive associated with the QOF.

If a QOF owner intends to distribute a QOF upon death, the owner may want to consider providing additional funds to the recipient to cover the potential income tax liability.


A potential alternative to a QOF

For individuals looking for ways to potentially defer federal capital gains tax liability and may be considering a QOF, a 1031 exchange may be a potential alternative. The 1031 exchange predates a QOF and both are designed to reduce or eliminate capital gains tax liability. While the potential tax benefits are similar, there are also important differences between these 2 strategies, including the fact that an intermediary may be required to complete a 1031 exchange. A 1031 exchange allows a taxpayer to defer recognition of capital gains incurred upon the sale of an investment property by reinvesting the proceeds in a like-kind

property of equal or greater value within a certain time frame.⁸ To defer recognition of capital gains with a 1031 exchange, an individual must identify a replacement property within 45 days of the sale date of the current property and complete the purchase of the replacement property within 180 days. Individuals should work with their legal, tax, and financial advisors to determine which, if any, of these strategies may be appropriate for them.

In summary

Investing in a QOF may provide economically distressed areas with potentially significant funds and job growth, while at the same time providing investors/taxpayers with tax incentives to participate in the program. But caution should be taken when evaluating available QOFs to determine if the fund is a suitable option when seeking tax incentives, or if an alternative, such as a 1031 exchange, may be a better option. You should also check with your tax professional to determine whether your state is aligned with federal law with regard to qualified opportunity zones. Finally, further consultation with an attorney should be considered if the taxpayer is interested in gifting a QOF during their lifetime or if a QOF may be distributed as part of their estate.

1. Update: A taxpayer must have invested in a QOF prior to January 1, 2020 in order to receive the maximum 15% discount on the deferred eligible capital gains which will be reported as taxable income on December 31, 2026. Due to the COVID-19 pandemic, the IRS issued Notice 2020-39 which provides an extension for certain taxpayers to invest eligible capital gains. Specifically, the Notice provides that if "a taxpayer's 180th day to invest in a QOF would have fallen on or after April 1, 2020, and before December 31, 2020, the taxpayer now has until December 31, 2020 to invest that gain into a QOF."
2. State capital gains tax liability will vary depending on the state's conformity with the IRS Code.
3. List of QOZs available on the US Department of the Treasury's website at: <https://www.cdfifund.gov/opportunity-zones> .
4. Source: Section 144(c)(6)(B) of the Internal Revenue Code.
5. Long-term capital gain rate assumes maximum rate of 20% plus 3.8% Medicare surtax.
6. Note that this example accounts only for federal capital gains taxes. State capital gains tax liability will vary depending on the state's conformity with the IRS Code.
7. Note that the recognition of the step-up in cost basis happens at year end following the 5 year holding period. The 7 year holding period and 15% adjustment are only available if a qualifying investment occurred prior to January 1, 2020.
8. Program defined under Section 1031 of the Internal Revenue Code. In general, properties are of like-kind if they are of the same nature or character, even if they differ in grade or quality.

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