Tax Notes

Opportunity Knocks as Treasury Issues Proposed Income Tax Regulations on Qualified Opportunity Zone Funds

By Alan S. Kufeld, CPA, Partner and Leo Parmegiani, CPA, Partner

The Internal Revenue Service recently issued long awaited proposed regulations along with Revenue Ruling 2018-29 answering many, but not all, of the key unresolved points surrounding investing in qualified opportunity zone funds (QOZFs). As outlined in our previous *Tax Notes* article, the Tax Cuts and Jobs Act of 2017 (TCJA) created QOZFs, a new tax incentive program designed to stimulate an influx of new investment capital into certain economically distressed communities throughout the country. The program enables investors with unrealized capital gains to receive significant tax incentives for investing in these funds. While these QOZFs are still in the early stages of creation, taxpayers are gearing up for their use as there are few other tax benefits like this in the TCJA.

The proposed regulations released last week clarify the type of gains that qualify for deferral, the timing for investing one's gains into a qualified opportunity fund as well as other guidance. The Treasury Department also indicated that it plans to issue additional guidance before the end of the year. These new regulations, although proposed, can be relied upon for structuring investments.

Some of the key issues that were clarified in the October 19, 2018 proposed regulations are outlined in this e-newsletter.

Types of Gains Eligible for Deferral

The regulations confirm that only capital gains recognized no later than December 31, 2026 are eligible for tax deferral. Gains that are ordinary in nature (e.g., from the sale of inventory) are not eligible. Eligible interests in a QOZF must be an equity interest, including preferred stock or a partnership interest with special allocations. An eligible interest cannot include a debt instrument.

The Election

Eligible taxpayers including individuals, partnerships, certain pass-through entities and C corporations can make this deferral election on Form 8949 along with the filing of their tax returns.

Partners of Pass-Through Entities May Also Make an Investment in the QOZF

Partners of partnerships and other pass-through entities may invest in a QOZF, if done within 180 days of the partnership's taxable year-end. This provision allows the gain recognized by a partnership to flow through to its partners, where the partner can reinvest their distributive share of capital gains into a QOZF, unless the partnership elects to invest the gain in a QOZF itself. Previously, it was unclear if the partner or the partnership had to make the election to reinvest.

The partnership's 180-day period begins on the date it sells the capital asset, but if the gain flows through to the partners of the pass-through entity, the partners' 180-day period does not commence until the last day of the partnership's taxable year.

Land Is Disregarded

When determining the amount of the substantial improvements that must be made to a property acquired that contains both land and building in a qualified opportunity zone, the portion attributable to land will be disregarded and will not be required to be substantially improved to meet the 90% asset test as explained in our prior article. This is applicable when buildings are acquired and are not of original use. This is clearly a taxpayer friendly change as it will be less capital intensive for the purchaser.

For example, if a fund were to pay $1 million for a warehouse inclusive of land, with the building valued at $400,000, the fund is required to spend at least what the building is valued at — not the total purchase price — in renovations. In this example, $400,000 needs to be used for substantial improvements.

Market Reaction

Several notable investment funds have already begun offering QOZ funds within their overall investment strategies. Although some additional clarity is needed, the proposed regulations may be sufficient for deals to close before year-end. The next set of regulations is expected to cover questions about the ongoing operation of the QOZFs.

What's Next?

The income tax regulations are still in proposed form, subject to further change, but may be relied upon as we await final regulations. The regulations are certainly taxpayer friendly, as Treasury continues to push for significant capital to be raised in the designated areas.

We will continue to monitor guidance as it is released by the Internal Revenue Service and will provide updates as information is available. As mentioned above, additional regulations are expected adding further clarity. A public hearing requesting comments is scheduled for January 10, 2019.

Our future articles on this tax incentive opportunity will discuss how funds can perform self-certification to ensure IRS criteria are met.

Contact Us

For more information, please contact either of the following partners or your PKF O'Connor Davies tax advisor:

Alan S. Kufeld, CPA
Partner
akufeld@pkfod.com | 646.449.6319

Leo Parmegiani, CPA
Partner
lparmegiani@pkfod.com | 646.699.2848

About PKF O'Connor Davies