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Capital Gains

‘Opportunity Zone’ Tax Regs Move Ahead, Get Budget Office Review

By Siri Bulusu

Investment fund managers are a step closer to getting clarity on how to use a tax incentive to invest capital gains in low-income area development.

The Office of Management and Budget's Office of Information and Regulatory Affairs is reviewing proposed rules for the “opportunity zones” tax incentive—the last major hurdle before proposed guidance is released by Treasury and the IRS.

The incentive, part of last year's tax overhaul (Pub. L. No. 115-97), has drawn a lot of attention from investors and could tap into an estimated $6 trillion in idle capital gains, according to an analysis of Federal Reserve data by the Economic Innovation Group, a bipartisan public policy organization based in Washington.

Goldman Sachs created an opportunity fund, days after the 2017 tax overhaul passed, to invest in New York and New Jersey. And Steve Glickman, former senior economic adviser to President Barack Obama, is starting a consulting firm to help investors navigate the new tax break and help deploy funds into roughly 8,700 low-income areas that have been deemed “qualified opportunity zones (QOZs).”

But without final rules, fund managers can't guarantee whether the tax break will pan out as expected.

The tax break reduces the tax liability on capital gains when they are recycled into designated areas—opportunity zones—seeking a variety of investments that will drive economic development. Capital gains earned on the new investments are exempt from capital gains tax when held for more than 10 years.

“Investors are eagerly waiting to see if the proposed rules address the core essentials—issues pertaining to key definitions and timing considerations that will make or break their ability to use the incentive in the real world,” said John Lettieri, co-founder and president of the EIG.

“Not all regulatory questions are equally critical at this stage,” Lettieri said. “Most investors aren't willing to commit their capital until Treasury releases clear rules of the road.”

Opportunity Funds

Money invested into qualified opportunity zones must be deployed through a qualified opportunity fund (QOF). Those funds can enjoy tax benefits in three ways:

- Capital gains recycled into a QOZ are deferred until the sale of the fund or until Dec. 31, 2026.
- The initially invested amount of capital gains exposed to tax is reduced by 10 percent if the investment is held for 5 years and an additional 5 percent if the investment is held for 7 years.
- The gains earned by the QOF are exempt from capital gains tax if the investment is held in the fund for more than 10 years.

Tax practitioners said clients are getting frustrated by the lack of guidance. While some individual and family investors are willing to take risks and deploy capital prior to the final rules, larger clients are struggling to attract investors due to lack of clarity.

“I have a client that wants to raise a multi-investor fund to develop a $500 million mixed-use project and is waiting for

regulatory guidance to proceed because of the inability to give investors sufficient comfort that the project will qualify under the opportunity zone rules,” Scott Bakal, partner at Neal, Gerber & Eisenberg LLP, told Bloomberg Tax in a Sept. 13 email.

Bakal said when investors give money to funds in private offerings they expect tax advice to be backed with a level of certainty that gives a two-thirds chance of success on an audit should the tax position be challenged by the IRS.

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