

## Pandemic Extensions May Save Opportunity Zone Investment

By **Tucker Thoni and Elisabeth Crane** (June 22, 2020, 7:03 PM EDT)

The Internal Revenue Service recently issued Notice 2020-39 providing relief needed due to COVID-19-related delays for taxpayers that have made, or are considering making, investments in a qualified opportunity fund, or QOF. The relief is in the form of extended or tolled compliance time periods and temporary respite from the penalty imposed on QOFs for failing a semi-annual asset test.

IRS Notice 2020-39 builds on the prior relief provided by IRS Notice 2020-23,[1] but is focused specifically on qualified opportunity zone investments.

For existing QOF investments, the additional time provides flexibility, during the COVID-19 related shutdowns, to stay compliant with the various requirements imposed by the qualified opportunity zone tax regime and to avoid penalty for certain noncompliance. The relief will also be beneficial for taxpayer-investors that are considering participation in the opportunity zone tax incentive program but are hesitant to make investments in the current economic climate, and who need more time to reassess their projects and analyze when business and lending activity might stabilize.

The current COVID-19 related economic disruption has made it difficult to plan and carry out opportunity zone projects, which are often complex projects requiring new construction or substantial improvement renovations with respect to real estate and start-ups, or new locations with respect to operating businesses. Such development activity is precarious, if not unfeasible, when a majority of the country is under a stay-at-home order.

The relief provided by IRS Notice 2020-39, discussed below, was prudent and necessary for the viability of the opportunity zone tax incentive program, as many taxpayers would have been subject to penalty for failing out of compliance with one of the many time sensitive obligations imposed on opportunity zone investments, including but not limited to, initial investment, capital allocation of invested funds, property improvement, property holding period, property use and reinvestment of cash proceeds from the sale of opportunity zone property.

Penalizing taxpayers for temporal noncompliance when the delay in complying with such obligations, in many instances, is due to forces beyond the investor's control would have been inequitable and



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significantly undermined taxpayer confidence in the opportunity zone tax incentive program.

### **Postponement of 180-Day Investment Period**

In order to defer capital gain under the qualified opportunity zone tax incentive program, taxpayers generally must invest the gain in a QOF within 180 days of when such gain is recognized.[2] In the case of pass through entities, such as partnerships or S corporations, there is flexibility with respect to when the 180-day clock starts ticking.

In IRS Notice 2020-23, which was issued on April 6, the IRS extended 180-day investment periods expiring on April 1 through July 14 until July 15.[3]

IRS Notice 2020-39 extends 180-day investment periods expiring on April 1 through Dec. 30 until Dec. 31.[4] Accordingly, taxpayers recognizing capital gain on or after Oct. 3, 2019 will have until Dec. 31 to make a tax deferred investment in a QOF.[5] The extension discussed above is automatic, so taxpayers do not need to make any special extension filings to benefit from this relief.[6]

For example, a taxpayer recognizes \$1 million of capital gain on Dec. 15, 2019, and validly extends the time for filing his 2019 IRS Form 1040 individual tax return until Oct. 15.

As of Oct. 15, the taxpayer intends to invest all \$1 million of capital gain into a QOF on Dec. 1, and so taxpayer defers all \$1 million on IRS Form 8949 filed with the individual income tax return.

On Dec. 1, the QOF sponsor indicates that the QOF investment has been cancelled due to COVID-19-related market issues — or another event occurs — which results in the taxpayer investing less than \$1 million in the QOF.

It is unclear how the taxpayer would report the above situation. It appears that there are two principal options: (1) treat the failure to make the anticipated opportunity zone investment as tantamount an inclusion event at the point the investment is abandoned — but no later than Dec. 31 — and report the gain as being recognized in calendar year 2020, or (2) amend the 2019 IRS 1040 individual tax return and include the gain in the 2019 tax year.

To be clear, IRS Notice 2020-39 does not provide guidance on how the taxpayer should report the above conundrum. Tax advisers need to determine how to properly report opportunity zone investments for state or federal income tax purposes. It is important to remember that opportunity zone investments are a tax shelter, and as such, it is probable that such investments will be subject to heightened scrutiny by the IRS

### **90% Investment Standard for QOFs**

A QOF must hold at least 90% of its assets in qualified opportunity zone property as determined on semi-annual testing dates.[8] There is a steep, monthly penalty imposed on QOFs that fail a semi-annual asset test, which increases in proportion to the extent by which QOF fell short of the 90% requirement.[9]

The penalty is excusable if a QOF can demonstrate that its failure to maintain 90% of its assets in qualified opportunity zone property is due to a reasonable cause.[10]

Notice 2020-39 provides relief for QOFs that might otherwise be subject to the asset test penalty. Indeed, the failure of a semi-annual asset test occurring between April 1 and Dec. 31 is automatically deemed to be due to reasonable cause.[11] Therefore, failing a semi-annual asset test occurring between April 1 and Dec. 31 should not result in a penalty for QOFs.

Moreover, the failed asset test is disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the various holding period, use and other requirements imposed by the opportunity zone tax regime.

The practical effect of the above extension is that for calendar-year QOFs[12] that have raised capital in 2020, including investors creating new QOFs in 2020, the deadline to place such capital into qualified opportunity zone property or qualified opportunity zone businesses, or QOZBs, is now June 30, 2021.

This change creates tax reporting issues for QOFs because IRS Form 8996 requires QOFs to self-report the semi-annual asset tests and penalty, if any. Notice 2020-39 acknowledges these concerns — and in contrast to the 180-day investment period — provides useful guidance. The QOF should fill out IRS Form 8996 with all its correct information, except that on Part IV, Line 8 regarding the amount of the penalty, the QOF should enter zero.[13]

### **Extension of 31-Month Safe Harbor for Working Capital**

QOZBs are subject to a myriad of technical requirements. There are four separate but related safe harbors, so-called working capital safe harbors, that provide an initial 31-month grace period wherein an entity can get in compliance with the requirements imposed on QOZBs.[14] The 31-month working capital safe harbor period can be extended to 62 months, if certain conditions are met.[15]

Moreover, if the QOZB holds tangible property located in a federally declared disaster area, the safe harbor period can be extended up to an additional 24 months.

As a result of President Donald Trump's March 13 COVID-19 emergency declaration,[16] all QOZBs holding tangible assets subject to a working capital safe harbor protection on or after March 13 and prior to Dec. 31 will have an additional 24 months, so long as other requirements are met to qualify for the safe harbors.

The additional 24 months will provide relief to QOZBs that have experienced COVID-19-related delays that have caused the QOZBs to deviate from their working capital written schedules.

### **Extension of 30-Month Substantial Improvement Requirement**

In order for tangible property to constitute qualified opportunity zone property, the property must be (1) original use property, or (2) substantially improved.[17] Substantial improvement generally requires that the QOF or QOZB, as applicable, double its basis in the property within 30 months of acquisition. Notice 2020-39 tolls the 30-month substantial improvement period from April 1 through Dec. 31.

In effect, Notice 2020-39 extends by 9 months the 30-month substantial improvement time period for all tangible property held by QOFs and QOZBs, as the Tax Cuts and Jobs Act of 2017 was passed less than 30 months prior to April 1. Therefore, the 30-month substantial improvement window has yet to close for any such property. The extension will not be of any practical relief for QOFs or QOZBs that have completed their substantial improvement projects prior to April 1.

## Extension of 12-Month Reinvestment Period

If a QOF receives proceeds from the return of capital, or the sale or disposition of some or all of its qualified opportunity zone property, and the QOF reinvests some or all of the proceeds in qualified opportunity zone property within 12 months of such event, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90% semi-annual asset tests.

The U.S. Department of the Treasury regulations provide that the 12-month window for QOFs that receive proceeds from the return of capital or sale of qualified opportunity zone property to reinvest the proceeds in other qualified opportunity zone property<sup>[18]</sup> is extended for an additional 12 months if the plan to reinvest the proceeds is delayed due to a federally declared disaster area,<sup>[19]</sup> so long as (1) the QOF reinvests the proceeds in the manner originally intended before the disaster, and (2) the QOF's reinvestment plan is delayed due to the disaster.

Pursuant to Notice 2020-39, the additional 12-month reinvestment period is applicable to any initial 12-month reinvestment period in effect as of Jan. 20. The extension is due to Trump's major disaster declarations under the authority of the Stafford Act with respect to all 50 states, the District of Columbia, and five U.S. territories.<sup>[20]</sup>

The extended time frames afforded to opportunity zone investments pursuant to IRS Notice 2020-39, discussed above, are very taxpayer friendly, and should foster confidence and additional investment into the opportunity zone regime by giving investors more time to evaluate proposed, and execute existing, opportunity zone projects that have been sidetracked due to COVID-19.

Indeed, the opportunity zone tax regime contains a myriad of time sensitive obligations regarding initial investment, capital allocation of invested funds, property improvement, working capital, property holding period, property use and reinvestment, all of which were in jeopardy due to a delay not attributable to any investor, but rather, to a pandemic. Failing to provide this relief would have imposed rough justice on many taxpayers, which in turn would have resulted in a lack of confidence in the opportunity zone tax incentive program.

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[1] IRS Notice 2020-23.

[2] Treas. Reg. § 101400Z2-1(c)(8).

[3] IRS Notice 2020-23.

[4] IRS Notice 2020-39.

[5] Id.

[6] Id.

[7] See updated instructions providing how to report eligible gains from Qualified Opportunity Zone Business Property on Form 8949, <https://www.irs.gov/forms-pubs/how-to-report-eligible-gains-from-qualified-opportunity-zone-business-property-on-form-8949>.

[8] IRC § 1400Z-2(d)(2)(D); Treas. Reg. § 1.1400Z(d)-2(d)(3).

[9] IRC § 1400Z-2(f)(1).

[10] IRC § 1400Z-2(f)(3).

[11] IRS Notice 2020-39.

[12] For QOFs that report on the fiscal year, the analysis is different, and the variables of which are beyond the scope of this article.

[13] For additional information, see <https://www.irs.gov/forms-pubs/about-form-8996>.

[14] See Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v).

[15] See Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi).

[16] That is, the declaration of a Federally declared disaster for purposes of IRC § 165(i)(5)(a). See March 13, 2020, letter from the President to Secretaries of the Departments of Homeland Security, the Treasury, and Health and Human Services and the Administrator of the Federal Emergency Management Agency, available at <https://www.whitehouse.gov/wp-content/uploads/2020/03/LetterFromThePresident.pdf>.

[17] Treas. Reg. § 1.1400Z(d)-2(b)(3), (4).

[18] Treas. Reg. § 1.1400Z2(f)-1(b)(1).

[19] IRC § 165(i)(5)(A).

[20] See <https://www.fema.gov/coronavirus/disaster-declarations>.