The IRS Provides Relief for Qualified Opportunity Funds and Their Investors

Alert
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By Tom Molins, Charley Jensen and Allison Woodbury

In recognition of the disruption and the practical difficulties of complying with tax obligations due to the COVID-19 pandemic, the IRS has provided relief to taxpayers in a variety of contexts. On June 4, 2020, the IRS released Notice 2020-39 to provide some relief to qualified opportunity funds (QOFs) and their investors.

The opportunity zone program, enacted as part of the 2017 Tax Cuts and Jobs Act, provides tax incentives to spur investment in low-income communities. To be eligible for these tax benefits, a number of requirements need to be satisfied by investors and the QOFs, many of which require that investments be made and that capital be deployed within certain specified time periods. In Notice 2020-39, the IRS has provided the following forms of relief:

- Additional time for taxpayers to timely make an investment in a QOF
- Forgiveness for a QOF that fails to satisfy the 90% asset test
- Tolling of the 30-month substantial improvement period
- Extension of the working capital safe harbor period
- Additional time to satisfy the reinvestment requirement

Additional Time to Satisfy the 180-Day Investment Requirement. In order to be eligible for the tax benefits under the opportunity zone program, a taxpayer generally is required to make an equity investment in a QOF within 180 days of realizing capital gain. In Notice 2020-39, the IRS provides if a taxpayer's 180th day to invest in a QOF falls on or after April 1, 2020, and before December 31, 2020, the last day of that 180-day period is postponed to December 31, 2020. The relief is automatic and taxpayers need not apply for or elect this relief – though the notice also reminds taxpayers that they still need to file IRS Form 8949 to make a valid deferral election and complete IRS Form 8949 to report their QOF investments.

Relief for Failure to Satisfy 90% Asset Test. A QOF is generally required to hold at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held by that QOF as measured (1) on the last day of the first six-month period of the taxable year of the QOF, and (2) on the last day of the taxable year of the QOF. A QOF has to pay a penalty for each month that it fails to satisfy this test, unless the failure is due to reasonable cause. In Notice 2020-39, the IRS stated that in the case of a QOF (1) whose last day of the first six-month period of the taxable year or (2) last day of the taxable year falls within the period beginning on April 1, 2020, and ending on December 31, 2020, any failure to satisfy the 90% investment test is automatically considered to be due to reasonable cause and disregarded for purposes of whether the qualification requirements were satisfied. Again, this relief is automatic and taxpayers need not apply for this relief. A QOF must still accurately complete and file Form 8996 to report whether it satisfied the 90% test, but the notice instructs QOFs that fail to satisfy the 90% test to just fill in "0" as the amount of the penalty owed for that failure.

Tolling of the 30-Month Substantial Improvement Period. In order for tangible property to be treated as qualified opportunity zone business property (QOZBP), either (1) the original use of such tangible property in the qualified opportunity zone must begin with the QOF (or qualified opportunity zone business (QOZB)) or (2) the QOF (or QOZB) must substantially improve that property. In other words, if tangible property was already used in a qualified opportunity zone when purchased by a QOF or QOZB, then it needs to be substantially improved by the QOF or QOZB before it can become QOZBP. To meet the substantial improvement requirement, the QOF (or QOZB) must, during the 30-month period beginning after the date of acquisition of the tangible property, double the adjusted tax basis of the property by making improvements to it. In Notice 2020-39, the IRS stated that the period beginning on April 1, 2020, and ending on December 31, 2020 is disregarded in determining the 30-month period. In other words, the IRS has tolled the period beginning on April 1, 2020 and ending on December 31, 2020 for purposes of the substantial improvement requirement.

Extension of Working Capital Safe Harbor period. When a QOF operates through a QOZB, there are a number of additional requirements that must be satisfied. In order to qualify as a QOZB, less than 5% (as measured by average tax basis) of the entity's property must be attributable to "nonqualified financial property" – which is defined to include cash. In recognition of the fact that it may take time to deploy capital, reasonable amounts held as working capital are excluded from the definition of nonqualified financial property. The regulations provide QOZBs with a safe harbor for treating an amount of working capital as reasonable. In order to qualify for the safe harbor, there must be a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets. In Notice 2020-39, the IRS provided that, as a result of the emergency declaration issued by the President in response to the ongoing COVID-19 pandemic, all QOZBs holding working capital assets intended to be covered by the working capital safe harbor before December 31, 2020, will receive an additional 24 months to expend the working capital assets of the QOZB.

Additional Time to Satisfy 12-Month Reinvestment Requirement. If a QOF sells qualified opportunity zone property or receives a distribution of cash as a return of capital and if it reinvests some or all of the proceeds in qualified opportunity zone property within 12 months, the reinvested proceeds are treated as qualified opportunity zone property. This rule allows a QOF 12 months to reinvest those amounts without penalty. Regulations currently allow a QOF to an additional 12 months to reinvest proceeds if the QOF's plan to reinvest the proceeds is due to a federally declared disaster. In Notice 2020-39, the IRS provided that if a QOF's 12-month reinvestment period includes January 20, 2020, the QOF has up to an additional 12 months to reinvest in qualified opportunity zone property.

While there was initial excitement about the possibilities that the opportunity zone program offered after the enactment of the 2017 Tax Cuts and Jobs Act, the legislation itself left many unanswered questions and uncertainties for investors. The IRS issued two sets of proposed regulations and, after receiving many comments from investors and industry participants, issued final regulations in December of 2019. Soon thereafter the COVID-19 pandemic hit, which wreaked havoc on businesses and investment plans across all sectors, including those located in opportunity zones. The need for investment in economically distressed areas is even more acute today. While the recent protests and demonstrations have been targeting a different societal issue, they may also spur interest in making investments in areas populated by those who have suffered from racial injustices, which areas are often located in opportunity zones. By giving investors more time to invest in QOFs and by easing some of the qualification requirements for QOFs, Notice 2020-39 should help the opportunity fund program fulfill its lofty objectives and also provide opportunities to those who have suffered disproportionately from the effects of the COVID-19 pandemic.

For more information on the impact of Notice 2020-39 on qualified funds or about opportunity zone funds generally, please contact Tom Molins, Charley Jensen, Allison Woodbury or the Stinson LLP contact with whom you regularly work.

CONTACTS

Charles F. Jensen

Thomas N. Molins

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