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3 Lingering Opportunity Zone Questions Amid The Pandemic.

The COVID-19 pandemic has severely slowed the commercial real estate market as investors are skittish and banks are reluctant to loan, and while the IRS on Thursday provided important relief for investors in opportunity zone projects, questions and hurdles for such deals still remain.

One of the lingering questions about the opportunity zone program created as part of President Donald Trump's late 2017 tax overhaul is how to satisfy a requirement that at least half of employment at opportunity zone businesses take place within the zone, which at the moment is tricky given that so many people are working remotely amid the pandemic.

And while changes earlier this week from the IRS will help current investors and projects, challenging timeline requirements still exist for would-be investors. The program allows investors to defer payment of capital gains if those gains are put into an opportunity zone, and gains on the opportunity zone investment are also tax-free if the position is held for 10 years.

Here, Law360 looks at three lingering questions about opportunity zones amid the COVID-19 pandemic.

Will tax and employment concerns weigh on investors?

The IRS on Thursday granted several timeline extensions for opportunity zone investors, and lawyers say that while the changes are important for current projects, tax and employment issues remain.

Investors using the program must put capital gains into an opportunity zone fund within 180 days of a sale, and the IRS on Thursday said if that 180-day point occurs or occurred between April 1 and Dec. 31, the deadline to invest in a fund is now Dec. 31.

Likewise, if projects between April and the end of year had hit the law's requirement that 90% of assets in a fund be in an opportunity zone project, projects get an exemption from that requirement until the end of the year. And the months between April and December also will not count toward the required 30-month timeline during which developers have to add improvements to properties, the IRS said Thursday.

Michael Krueger, a partner at Newmeyer & Dillion LLP, said that 90% rule has been challenging for companies to meet during the pandemic, given construction and government approval delays.

But one lingering issue, according to John Gahan, a partner at Sullivan & Worcester LLP, is the question of where employees at opportunity zone projects work. As the law is written, at least half of employees' hours at an opportunity zone business need to occur within the opportunity zone, and that's still a big unknown given that so many employees are working from home amid the pandemic.

"If there is one [thing] missing in the relief, it is how to incorporate where people work," Gahan said. "Anything more probably needs to come from Congress."

And tax questions also remain. As the program stands, deferred gains are to be taxed in 2026, and there's concern in the investor community about what tax rates may be in 2026, said Kate Kraus, a partner at Allen Matkins Leck Gamble Mallory & Natsis LLP.

"That could be much higher than 2019-2020 tax rates. This is something that the Treasury and IRS can't address. Congress would need to enact new legislation," Kraus said.

And while the new guidance from the IRS helps those who are already in the midst of projects, it doesn't necessarily make it any easier for investors who are on the sidelines and hoping to dive into opportunity zones.

"If you have not already harvested your gain, doing so now, your 180 days would have been in December anyway," Gahan said. "So it helps those who already have gain. Maybe those who sold stock during the early days of pandemic."

How will investors approach the substantial improvement requirement?

Lawyers say the relief on the question of the 30-month clock for substantial improvements is helpful for current projects or projects that are in the works, although for would-be projects, that 30-month requirement still could pose timing problems, particularly in jurisdictions where entitlement is slow to come by.

The law requires developers to invest an amount in improvements equal to the value of the purchased building — but not the land — and to do so within 30 months.

While it's possible Congress could, say, lower that requirement to 50% of the building value, which would likely bring more investors to projects, Gahan said he doesn't expect to see calls for additional guidance at this point.

But there's another way investors could get around that tricky 100% requirement.

If investors purchase opportunity zone properties from the government through a bankruptcy sale, they can bypass that substantial improvement requirement altogether. And Krueger expects more of such opportunities in the near term.

"In 12 to 18 months, when all of the moratoriums on foreclosures are expired and people stop kicking the can down the road, [real estate] is going to crash," Krueger said. "It's a very unique situation where you can acquire something from the government."

And since struggling malls are already Americans with Disabilities Act compliant and on transportation lines, those could be the kinds of properties that end up changing hands, and if opportunity zone investors pick them up, substantial improvements may not be required, Krueger said.

"What I envision, and what I recommend to the politicians, is take these malls back that are vacant, and turn them into what is needed. … All of these malls are perfect locations for that," Krueger said. "The J.C. Penneys may now become Kaiser Permanente dialysis centers."

Will investors shift more focus away from real estate?

While much of the focus of opportunity zones has been real estate, the law also allows for investment in companies, and that option may become more attractive as construction and the real estate market writ large continue to be major unknowns.

“Whether credit is available or whether there’s labor, restrictions on labor, all of these things can have … an impact on an opportunity zone project,” said Matt Ertman, a partner at Allen Matkins. “It you can’t get entitlements done within the timelines, you’re going to have a tough time getting a project completed.”

And as Silicon Valley investors and entrepreneurs find themselves with capital gains from sale of stock — the Nasdaq on Friday hit a record high — those investors may look to opportunity zone investments in other companies, as opposed to brick-and-mortar real estate, as a tax strategy.

Krueger said he even thinks company human resources departments should help employees find options for such investments.

“Property itself may not be the most attractive investment now. [Capital] may go back into the startup companies. It doesn’t have to be real estate that you invest in in an opportunity zone,” Kreuger said. “What I am seeing is a large draw to disruptive technology. More fintech. More remote work, remote access. Those are more attractive.”

“Commercial real estate for a large tenant that’s going to put all of their employees in that one space, that’s no longer a sure thing,” he added.

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