Qualified Opportunity Zones: Delayed Timelines and Tracking Changes.

The opportunity zone program and its investors have not escaped the uncertainties and upheaval brought on by the pandemic. Christopher Hanewald of CBIZ & Mayer Hoffman McCann P.C. sorts out the guidance and outlines remaining questions.

During the past year, world events, including those in our country and even within our own neighborhoods, have led to an endless barrage of changes requiring near-constant adaptation.

Businesses across all industries have been presented with the perfect storm of challenges: chasing rapid shifts in consumer behavior while untangling a web of new legislation enacted to blunt the economic impact of the Covid-19 pandemic.

While each industry faces its own unique challenges, real estate owners, investors, and managers have seen demographic trends reverse course overnight as a new work-from-home culture allows workers to leave high-priced city centers in favor of spacious suburbs or even across state lines. More specifically within the industry, opportunity zone organizers and investors have been left to reassess projects at all stages of development. Following creation of the qualified opportunity zone (QOZ) program in the Tax Cuts and Jobs Act, interested parties waited nearly two years before regulations were finalized by the Treasury and the IRS. As QOZ projects across the country sought to move forward with this new-founded clarity in 2020, most aspects of business were put on an indefinite delay as the pandemic took hold. Now, after 500 pages of final regulations, multiple IRS notices, and deadline delays in the last 15 months, it is time to take stock of what we know, what has changed, and finally review what we still wonder about.

Starting with the easy part—what we know. Except for changes implemented by the notices discussed below, the original QOZ framework remains mostly intact. Eligible gains (i.e., a gain treated as capital by the Internal Revenue Code) must be reinvested into a qualified opportunity fund (QOF) within 180 days. Exceptions do apply to the 180-day window for gains recognized by partners in a partnership.

Upon receipt of investor funds, the QOF must then turn its attention to its first applicable 90% testing date. While the timing of such testing date has been subject to changes, the manner in which a QOF satisfies the test remains the same: (1) invest at least 90% of the QOFs assets in qualified opportunity business property (QOZBP); or (2) invest at least 90% of the QOFs assets in stock or partnership interests of a qualified opportunity zone business (QOZB). The former requires a QOF to directly operate a trade or business while the latter permits a QOF to simply hold interests in a lower tier trade or business that satisfies QOZB requirements. QOFs must test their capital deployment on the last day of the first six-month period of the tax year and again on the last day of the tax year—reporting the results of those two tests on Form 8996 which is attached to the QOF’s tax return. Regardless of structure, the trade or business operated by the QOF or QOZB must meet tax code Section 162 trade or business requirements as supplemented by the QOZ final regulations—be wary of triple-net lease "businesses."

QOZBs, on the other hand, are subject to the so-called 70% test, which requires a QOZB to have at least 70% of all its tangible property qualify as QOZBP. For property to qualify as QOZBP, such property must be: (1) acquired by purchase or lease after Dec. 31, 2017; (2) the original use of the property in the QOZ must have commenced with the QOZB or the QOZB must substantially improve the property; and (3) during 90% of the QOZB's holding period of the tangible property, 70% of the use of the tangible property must have been in a QOZ. As a result of the lower testing threshold applicable to a QOZB, businesses are incentivized to utilize a two-tier operating structure in order to avail themselves of the 70% testing standard rather than operate an investment directly out of a QOF.

While the above only scratches the surface of QOZ operational requirements, it provides a baseline to begin discussing the changes implemented below:

- Notice 2020-23—On April 9, 2020, this notice was issued to provide broad relief in the form of deadline delays for taxpayers concerning a number of items. As it relates to QOZs, the notice extended the 180-day window for individual taxpayers to invest eligible gains in a QOF. Essentially, for any taxpayer whose 180-day investment window would have terminated on a date on or after April 1, 2020, such date was automatically extended to July 15, 2020.
- Notice 2020-39—On June 4, 2020, the IRS issued Notice 2020-39, which expanded upon the preceding notice to further delay the applicable deadlines. Specifically, this notice provided that if a taxpayer's 180-day investment window was to expire between April 1, 2020, and Dec. 31, 2020, the taxpayer's deadline was automatically extended to Dec. 31, 2020. Moreover, the notice introduced a reasonable cause exception for QOFs that exempted any QOF from statutory penalties for failure to meet the 90% test for any semiannual testing dates falling between April 1, 2020, and Dec. 31, 2020. Additionally, the notice suspended working capital safe harbor and substantial improvement timelines—the former of which provided for QOZBs to be eligible for not more than an additional 24 months to expend working capital assets.
- Notice 2021-10—Finally, on Jan. 19, 2021, the IRS issued this notice which further extended relief granted previously. For individuals, Notice 2021-10 again extended the 180-day investment window for any taxpayer whose ability to reinvest gains was supposed to expire between April 1, 2020, through March 31, 2021. Thus, a taxpayer with eligible gains from the latter part of 2019 will have the ability to potentially reinvest those gains up until March 31, 2021. Following suit with the previous Notice, a reasonable cause exception was provided for QOFs concerning the 90% test. Any failure to satisfy the 90% test between April 1, 2020, and June 30, 2021, will automatically be deemed to be due to reasonable cause with no penalty imposed. Furthermore, this notice provided additional time for any property being substantially improved—now allowing for up to 42 months for substantial improvement. As for working capital safe harbor plans, the notice is not clear whether all QOZBs utilizing such a plan automatically receive an additional 24 months or whether some evidence of actual delay must be presented.

The above mixture of delays and extensions is extremely taxpayer friendly. The extended 180-day investment window means that a taxpayer who recognized a capital gain realization event on or after Oct. 4, 2019, still can reinvest those eligible gains until March 31, 2021. Moreover, the reasonable cause delays for QOF testing requirements means that any QOF which was certified and accepted initial investments from taxpayers on or after June 30, 2019, will not be required to satisfy its first 90% test until Dec. 31, 2021. While these changes are certainly welcome, the constant stream of updates is increasing the complexity for a program that already has been deemed too complicated for some.

Now, a look ahead to identify what many QOZ organizers and advisors continue to wonder about. Despite more than $15 Billion of inflows to QOFs since the legislation's inception, there is still a surprising amount of uncertainty in a number of areas. At the outset, the barebones legislation and first round of proposed regulations strongly favored the real estate industry. Definitions related to substantial improvement and working capital safe harbor plans enabled real estate developments to begin moving dirt early in 2019; whereas investors interested in operating businesses were left speculating about how regulations apply to them. The questions below represent a sampling of areas for which more guidance can be expected:

- What is the impact of remote workers to the 50% income test required for QOZBs? Will reasonable cause exemptions be enacted for workforces disrupted by the pandemic?
- The applicability of 31-month working capital safe harbor plans in the context of developing a trade or business. Is this only applicable to real estate development and startups?
- Will going-concern businesses relocated to a QOZ be able to avail themselves of the safe harbor?
- Will further perimeters or limitations be implemented concerning QOF reinvestment of gains upon a sale at the QOZB level? Will a limit be instituted for how many times a QOF can fail the 90% test?

The above is by no means an exhaustive list of questions; however, they do represent areas in which significant uncertainty still exists. In addition to those questions, investors face external headwinds with the potential to alter the cost-benefit analysis of a potential QOZ investment. A new presidential administration brings with it the potential for an increase in capital gains rates—a drag on future investment returns as it relates to the initial eligible gain. Proposed legislation may seek to increase administrative reporting requirements for managers of QOFs, as the government makes a push to quantify the effect and benefits of the QOZ program. Finally, investors desiring a 10% basis step-up as a result of their investment will need to deploy capital before Dec. 31, 2021, in order to satisfy the 5-year holding requirements prior to the 2026 deadline when taxes on the original eligible gains are due. Interested parties will need to continue to monitor developments and work with their tax advisors to understand and navigate the ever-shifting landscape.

Bloomberg Law

March 12, 2021

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