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OPPORTUNITY ZONES: COVID-19 AND GUIDANCE UPDATES/NEW PLANNING OPPORTUNITIES

Opportunity Zone Program

The opportunity zone program was created through the passage of tax reform in 2017, also known as the Tax Cuts and Jobs Act (P.L. 115-97). Over $10 billion dollars have been deployed into qualified opportunity zone investments. While the investment has slowed, COVID-19 and additional guidance has created renewed interest in utilizing this program to assist with underserved communities and to provide tax relief for investors. Discussions and drafts of proposed bills would extend the program and provide other favorable provisions to investors. As a result, planning opportunities exist for new investments into the program, as well as for current investments.

Recent Guidance

Treasury and the IRS released final regulations and proposed regulations at the end of 2019. Additional guidance has been released in the form of correcting amendments, Notice 2020-23, and Notice 2020-39.

Notice 2020-39

In Notice 2020-39 the IRS provided relief to qualified opportunity funds (QOFs) and their investors in response to the COVID-19 pandemic. Additionally, the IRS has updated its Qualified Opportunity Zones frequently asked questions. The guidance provided the following relief:

- 180-day Investment Requirement – Investors are required to make investments in a QOF within a 180-day period. Because of the COVID-19 pandemic, the IRS released Notice 2020-23, which extended the window to make investments to July 15, 2020, for any 180-day deadline that would have ended between April 1, 2020, and July 15, 2020. Notice 2020-39 has extended this deferral period. If a taxpayer's 180th-day investment requirement falls between April 1, 2020, and before December 31, 2020, the taxpayer now has until December 31, 2020, to invest that gain into a QOF. This relief is automatic if Forms 8949 and 8997 are completed and included with the timely filed tax return (including extensions) or an amended return. The December 31, 2020, extension will not apply to partnerships and S-corporations that have a March 15 deadline.
- Reasonable Cause Exception - There is a 90% investment standard test that must be performed at six-month intervals. The final regulations provide for a reasonable cause exception. The final regulations did not provide a definition or give any clear guidance. There is no bright-line test and there is no specific procedure for requesting the reasonable standard relief. This notice states that a QOF's failure to pass the 90% test on any semiannual testing dates from April 1,

2020, through December 31, 2020, will be considered to be due to reasonable cause and that the failure will not prevent qualification of an entity as a QOF or an investment in a QOF from being a qualifying investment. The QOF will not be liable for the statutory penalty for any failures to meet the asset testing during this period. The QOF, however, must complete all lines on the annual filing of the Form 8996 – Qualified Opportunity Fund. This relief is automatic. If this exception applies, the taxpayer should place a zero in Part IV, line 8, "Penalty" on this form.

- Substantial Improvement – Under the final regulations, "substantial improvement" must be made within any 30-month period beginning after the date of acquisition of the applicable property. This notice suspends the 30-month substantial improvement for the period beginning on April 1, 2020, and ending on December 31, 2020.
- Working Capital Safe Harbor for Qualified Opportunity Zone Business (QOZB) - The working capital safe harbor allows a QOZB to hold working capital if it has a written plan to expend the funds within 31 months. The final regulations provide that an extension of not more than 24-months may be provided if the QOZB is within a federally declared disaster area. When the guidance was written, the focus was on disasters such as hurricanes and tornados. However, on March 13, 2020, President Trump declared a nationwide emergency pursuant to Section 501(b) of the Stafford Act. In response to COVID-19, all 50 states have been declared federal disaster areas. Notice 2020-39 confirms that due to the COVID-19 Emergency Declaration, all QOZBs holding working capital assets intended to be covered by the working capital safe harbor before December 31, 2020, will receive not more than an additional 24 months to expend the working capital assets of the QOZB (as long as the QOZB meets the requirements for the working capital safe harbor).
- 12-month Reinvestment Period – If a QOF sells a property or has a return of capital, it has 12 months to reinvest the proceeds in a QOZ qualifying investment without impacting the 90% investment standard. The final regulations provide for an additional extension of 12 months if the reinvestment is delayed due to a federally declared disaster, provided the QOF invests the proceeds in the manner originally intended before the disaster. This guidance allows an additional 12 months for reinvestment if any of the QOF's 12-month reinvestment period includes January 20, 2020 (the date of the disaster identified in the Major Disaster Declarations related to COVID-19).

Correcting Amendments

The Treasury Department and the Internal Revenue Service recently issued correcting amendments to the opportunity zone final regulations under Section1400Z, that were previously released on December 19, 2019. The correcting amendments are effective on April 1, 2020, and, are applicable as of January 13, 2020. While there were numerous changes, the following provides a summary of the key provisions.

- The correcting amendments broaden the scope of the QOF investments that are required to be reported on the IRS Form 8997. The final regulations required taxpayers that have qualifying investments in a QOF to report the investments held as of the end of each taxable year. The correcting amendments expand this to include a reporting requirement for any qualifying investment held at any point during the taxable year.

- The correcting amendments clarify the application of the alternative valuation method for purposes of a QOF's ownership of a subsidiary partnership or corporation treated as a QOZB. Taxpayers have two valuation options in determining the 90% asset test. The first is the applicable financial statement valuation method. The second is the alternative valuation method, which uses the unadjusted cost basis as the value of property purchased or constructed by the QOF. All other assets are to be valued pursuant to their fair market value. The correcting amendments stipulate that QOZ stock and QOZ partnership interests must be treated as purchased by the QOF. As such, the unadjusted cost basis must be used under the alternative valuation method.
- The correcting amendments provide that regulations may be applied on a section-by-section basis, not on its entirety. As such, taxpayers may use sections from the proposed regulations and others from the final regulations.
- The correcting amendments provide a clarification regarding the application of the working capital safe harbor. The final regulations provided that QOZBs could retain a reasonable amount of working capital under Section 1397C(e)(1) and this amount would not be included to determine the limitations on the "non-qualified financial property" test. The correcting amendments state that the cash from the initial contribution must be expended in accordance with the working capital plan of the QOZB, that any subsequent cash contribution must form an integral part of the working capital plan covering the initial contribution, and any subsequent cash contribution must constitute a substantial amount of the working capital. Based on this provision, it appears that a QOF cannot extend the safe harbor period by investing a de minimis amount of cash.

The correcting amendments further provide language that appears to state that during a working capital safe harbor period, an entity meets the 70% tangible property standard. Under this interpretation, the 70% tangible property standard would be suspended during the safe harbor period. As such, non-QOZB property (i.e., bad assets) would not impact the asset requirement. This provision is very beneficial for start-up entities.

Further, the correcting amendments clarify that working capital itself is never treated as QOZB property for any purpose. It is not included in determining the 70% tangible property standard.

Planning Opportunities

Delay Investment in Fund Post-June 30

A QOF that receives an investment before June 30, 2020, will be required to invest those funds within six months, or December 31, 2020. If a QOF delayed the receipt of those funds until sometime in July 2020, then the QOF will have until June 30, 2021, to invest those funds into qualified opportunity zone property. The testing is done every six months and the investment is given six months to be deployed, so there would be no issue with the December 31, 2020, testing. The next testing period will be June 30, 2021. Planning the receipt of funds is important and provides some flexibility.

Increased Stock Sales – Market Uncertainty

Many investors sold stock in reaction to COVID-19 to reap the capital gains. As a result, investors may have capital gains available to invest. Previously, some investors did not like the 10-year required holding period required to escape taxation on the gain during the time of the investment in the QOF. During this time of market uncertainty, the 10-year investment holding period may be more appetizing. The 10-year period may leap frog this uncertainty period. As a result, investors are looking at real estate projects and other businesses that may not have been previously considered. QOFs should be prepared to receive these funds that will likely expire in late summer or early fall.

Vacant Properties

The final regulations provided that the "original use" provision does not apply to property that has been vacant for three years, if it was bought by the QOF after 2018. The "original use" test would have required the investor to substantially improve the property. This is not required for these vacant properties, which would eliminate the significant funds required for substantial improvements. A building or land meets the rule of being vacant if 80% of its usable space is empty. As such, a large property that is still 20% leased would likewise be exempt from the "substantial improvement" rule. Additionally, buildings acquired directly from the government through bankruptcies or tax sales would not have to be substantially improved. There will likely be numerous abandoned, foreclosed, and government tax sales properties in opportunity zones as a result of COVID-19. These properties may now be more attractive due to the elimination of the "substantial improvement" requirement.

Net Operating Loss (NOL) Carryback

The CARES Act permits NOLs from 2020 to be carried back five years to offset taxable income. This can be particularly valuable if it is carried back to a year with a pre-tax reform tax rate (e.g., 35% for corporations). As such, investors want to increase the NOL in 2020. Taxpayers may wish to defer the gross (not net) capital gains by investing in a QOF, even in a loss year.

Bifurcation of Section 1231 Gains and Losses

Under the final regulations, investors do not need to net Section 1231 gains with Section 1231 losses. As such, investors do not need to wait until year end to invest in opportunity zones. Rather, an investor can invest the capital gain on the sale of business property into a QOF, while maintaining the loss amount separately. Accordingly, the Section 1231 loss, to the extent that it can create a NOL, can be carried back for five years, generating cash refunds (especially if it is at a pre-tax reform rate).

Bonus Depreciation and Cost Segregation

Property acquired and placed in service between September 27, 2017, and December 31, 2022, is eligible for 100% bonus depreciation. The CARES Act corrected the depreciable life of QIP from 39 years to 15 years. QIP is now bonus-eligible property. Pursuant to the opportunity zone final regulations, there is no bonus recapture. If the property is held for the 10-year period, an investor may create a permanent

tax benefit. As a result, cost segregation studies for non-commercial property are extremely valuable. You would get the deductions for bonus depreciation with no recapture and the step up in basis at the end of the 10-year holding period. If the QOZB elects to be a real property trade or business to prevent the Section 163(j) limitation, then bonus depreciation is not permitted. However, QIP would be reduced from a 39-year life to a 20-year life, which still provides tax benefits to the investors. Bonus depreciation may likewise result in NOL carrybacks that could be extremely valuable.

Working Capital Safe Harbor - Government Approvals

The final regulations also allow a QOZB to extend the 31-month period for project delays resulting from government approvals. Many government entities are limiting services. As such, any delay in permits or other approvals should be documented.

Conclusion

With COVID-19 and the resulting financial crisis, the Qualified Opportunity Zone program is a valuable tool for purposes of revitalizing distressed communities. Some state plans have already utilized the infrastructure of the program for their own investment incentive programs. Opportunity zones can assist in producing public-private partnerships that are critical for the recovery of distressed communities and will be needed for an increase in affordable housing and mixed-use projects, as well as job creation. Congress could provide additional incentives during this time of uncertainty to bring in additional capital investments. How Congress enhances the opportunity zone program will likely impact its durability. Funding for underserved communities is more important than ever and the opportunity zone program may be a key tool to revitalize these communities and the economy.