

# Opportunity Zone Pandemic Relief Is Welcome, But Limited

By **Jessica Millett** (February 11, 2021)

On Jan. 19, 2021, the Internal Revenue Service issued Notice 2021-10, which extends relief previously granted last June to opportunity zone investors in response to the COVID-19 pandemic.

The earlier relief was contained in Notice 2020-39, issued in June, but many of its provisions expired on Dec. 31, 2020. Given the ongoing pandemic, the U.S. Department of the Treasury and the IRS received numerous requests for additional relief.

The opportunity zone program is riddled with deadlines and time-sensitive requirements, so the further relaxation and extension of some of these deadlines and requirements is welcome news. Although the IRS did not include any new areas of hoped-for relief, the extension of the relief provisions from the June 2020 notice will be helpful for investors, qualified opportunity funds and qualified opportunity zone businesses.



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## **Deadline for Investing Eligible Gains**

To get the full suite of opportunity zone program tax benefits, a taxpayer must generally invest eligible gain into a qualified opportunity fund within the 180-day period beginning on the date on which the eligible gain is realized.

Additional timing rules apply to certain types of gain, such as gain allocated to a partner from a partnership. The 180-day investment period for this type, known as K-1 gain, can begin as late as the due date for the partnership's tax return, typically March 15 of the following year.

## **June 2020 Notice**

Notice 2020-39 stated that if a taxpayer's 180-day investment period ended on or after April 1, 2020, and before Dec. 31, 2020, the taxpayer had until Dec. 31, 2020, to invest eligible gain into a qualified opportunity fund.

## **New Guidance and its Impact**

Notice 2021-10 states that if a taxpayer's 180-day investment period ends on or after April 1, 2020, and before March 31, 2021, the taxpayer now has until March 31, 2021, to invest eligible gain into a qualified opportunity fund.

This extension is certainly helpful for potential investors, but it would have been even more helpful to have had this extension in place before Dec. 31, 2020, when the relief provided by the June 2020 notice expired.

Many investors rushed to get their qualified opportunity fund investments made by Dec. 31, 2020, so this new guidance is really only helpful to investors who (1) missed the prior deadline at the end of 2020 or (2) have a 180-day investment period that expires in the first quarter of 2021 since they now have a bit more time. Any procrastinators with 2019 K-1 gains get one more bite at the apple.

Note that this relief does not affect the deadline for the filing of Form 8949 and Form 8997, the forms that an investor uses to elect the deferral associated with a qualified opportunity fund investment, which must be timely filed by the taxpayer with its federal income tax return. At this point, any investors deferring 2019 gain will need to make the election in an amended return.

### **90% Asset Test for Qualified Opportunity Funds**

A qualified opportunity fund must hold at least 90% of its assets in qualified opportunity zone property, which is tested by averaging the percentages of qualified opportunity zone property measured on the last day of the first half of the taxable year and on the last day of the taxable year of the qualified opportunity fund, typically June 30 and Dec. 31.

Cash is not qualified opportunity zone properties, so a qualified opportunity fund has to invest its cash contributions relatively quickly. If a qualified opportunity fund fails to meet the 90% asset test, a penalty is imposed on the value of the qualified opportunity fund's assets that cause it to be out of compliance. However, no penalty is imposed if the failure is due to reasonable cause.

### ***June 2020 Notice***

If either of the qualified opportunity fund testing dates fell within the period beginning on April 1, 2020, and ending on Dec. 31, 2020, any failure by the qualified opportunity fund to meet the 90% asset test was automatically deemed to be due to reasonable cause, so there would be no penalty imposed on the qualified opportunity fund.

### ***New Guidance and its Impact***

The new notice extends this relief to testing dates that fall in the first half of 2021. Now, for any qualified opportunity fund testing dates that fall within the period beginning on April 1, 2020, and ending on June 30, 2021, any failure by the qualified opportunity fund to meet the 90% asset test is automatically deemed to be due to reasonable cause, so there will be no penalty imposed on the qualified opportunity fund.

This extension will be a relief to qualified opportunity funds and fund managers, given the continued uncertainty in the market. Many qualified opportunity funds that had planned to invest in qualifying property in 2020, especially in the spring and summer, were forced to delay, reschedule or abandon closings altogether.

This blanket reasonable cause relief gives most qualified opportunity funds until the December 2021 testing date before they have to worry about the 90% asset test.

Note that any qualified opportunity funds claiming this relief for 2020 are still required to timely file Form 8996, and they must accurately complete all lines on that form, including the percentage of qualified opportunity zone property. However, in Part IV, Line 8 (Penalty) of Form 8996, a qualified opportunity fund should put a "0" since a penalty would otherwise be imposed for any failures.

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

If a qualified opportunity fund or a qualified opportunity zone business acquires existing property, the property will only be qualifying tangible property to the qualified opportunity

fund or a qualified opportunity zone business if the property is substantially improved during a 30-month period beginning from the acquisition of the property.

Property can meet the substantial improvement test if the qualified opportunity fund or a qualified opportunity zone doubles its basis in the acquired improvements within the 30-month period. The basis attributable to the acquired land is ignored for purposes of this test.

### ***June 2020 Notice***

The period beginning on April 1, 2020, and ending on Dec. 31, 2020, would be disregarded for purposes of meeting the substantial improvement test. Any property that was in the midst of its 30-month substantial improvement period on April 1, 2020, therefore had a 39-month substantial improvement period.

### ***New Guidance and its Impact***

The new notice extends the end of the disregarded period from December 2020 to March 31, 2021. Now, the period beginning on April 1, 2020, and ending on March 31, 2021, will be disregarded for purposes of meeting the substantial improvement test.

Any property that was in the midst of its 30-month substantial improvement period on April 1, 2020, now has a 42-month substantial improvement period. Any new improvement periods that begin before April 1, 2021, have a few extra months before the 30-month clock begins.

Although construction has continued in certain markets during the pandemic, some projects have seen some sort of delay or even an outright forced stop to construction, so this relief will be hugely helpful to improvement projects in opportunity zones.

### **Tolling of 31-Month Working Capital Safe Harbor Background**

The final Treasury regulations to the opportunity zone program contain several relief measures applicable upon the declaration of a federal disaster. One of these measures allows a qualified opportunity zone business to toll its 31-month working capital safe harbor period by not more than an additional 24 months in the event of a federal disaster.

### ***June 2020 Notice***

The IRS confirmed that the emergency declaration in March 2020 triggered the federal disaster provisions in the Treasury regulations and that all qualified opportunity zone businesses with working capital assets intended to be covered by a working capital safe harbor before Dec. 31, 2020, were eligible to receive not more than an additional 24 months to spend the working capital.

### ***New Guidance and its Impact***

The new notice extends this relief from Dec. 31, 2020, to June 30, 2021. Thus, all qualified opportunity zone businesses with working capital assets intended to be covered by a working capital safe harbor before June 30, 2021, will receive not more than an additional 24 months to spend the working capital, for a maximum safe harbor period of not more than 55 months total, and not more than 86 months total for startup businesses.

One issue that remains uncertain is whether all qualified opportunity zone businesses automatically receive a full additional 24 months for their working capital safe harbor or whether qualified opportunity zone businesses must show evidence of an actual delay.

Until this is sorted out, our advice is to document everything. Keep track of: (1) when you had to shut down your office, (2) when various government offices where you submitted applications were closed, (3) when you got notice that your architect, contractor or consultant had to close their offices or stop working, and (4) when shelter in place or lockdown orders that affect your project were issued.

If you need to show an actual delay, you will want all of this information collected so you can count up the days.

### **Extension of Reinvestment Period Background**

A qualified opportunity fund that receives proceeds from either a sale of property or the return of capital typically has 12 months to reinvest those proceeds without taking those amounts into account for purposes of its 90% test. In the event of a federal disaster, a qualified opportunity fund can have an additional 12 months added to its reinvestment period.

#### ***June 2020 Notice***

Since the emergency declaration in March 2020 triggered the federal disaster provisions in the Treasury regulations, a qualified opportunity fund with a 12-month reinvestment period that included Jan. 20, 2020, had an additional 12 months to reinvest proceeds from either a sale of property or the return of capital, provided that the qualified opportunity fund invested those proceeds in the manner originally intended before Jan. 20, 2020.

#### ***New Guidance and its Impact***

The new notice extends this relief to reinvestment periods that include June 30, 2020.

Now, a qualified opportunity fund with a 12-month reinvestment period that includes June 30, 2020, has an additional 12 months, for a maximum reinvestment period of 24 months total, to reinvest proceeds from either a sale of property or the return of capital, provided that the qualified opportunity fund invests those proceeds in the manner originally intended before June 30, 2020.

### **Missed Opportunities**

Many opportunity zone stakeholders had hoped the next round of COVID-19 relief would address additional issues. A few glaring omissions include a qualified opportunity zone business's 50% gross income test and a qualified opportunity zone business's ability to change its working capital safe harbor plan.

#### ***50% Gross Income Test***

The 50% gross income test requires that 50% of a qualified opportunity zone business gross income be derived from the active conduct of a trade or business in an opportunity zone.

This requirement is more critical for operating business qualified opportunity zone

businesses than real estate qualified opportunity zone businesses, since real estate qualified opportunity zone businesses generally generate their income from real estate in an opportunity zone, which tends not to move.

For operating business qualified opportunity zone businesses, the Treasury regulations offer a number of safe harbors, several of which rely on the location of employees and independent contractors performing services for the qualified opportunity zone business.

If the services are performed in an opportunity zone, a qualified opportunity zone business may be able to rely on a safe harbor to meet the gross income test. However, many employees and other service providers are working remotely during the pandemic.

Many hoped the IRS would offer guidance on how to apply the location-based safe harbors during the pandemic, perhaps by treating services performed by employees while working remotely as if they had been performed in an opportunity zone, or by otherwise waiving the requirement for 2020 and 2021.

In the absence of guidance on this point, qualified opportunity zone businesses should ensure they can meet the 50% gross income test, either by meeting one of the location-based safe harbors or generally as a result of the facts and circumstances test.

### ***Working Capital Safe Harbor Plan***

A qualified opportunity zone business has a 5% limit on nonqualified financial property, but a qualified opportunity zone business can hold a reasonable amount of working capital.

If a qualified opportunity zone business properly documents and maintains a working capital safe harbor, its working capital assets are treated as reasonable in amount, and any financial property, such as cash, that is covered by the working capital safe harbor loses its otherwise disqualifying taint.

First, the working capital safe harbor must contain a statement in writing that the qualified opportunity zone business's working capital assets are designated for the development of a trade or business in an opportunity zone, including, if appropriate, the acquisition, construction and/or substantial improvement of tangible property in an opportunity zone.

Second, the working capital safe harbor must contain a written schedule for the planned expenditure of the working capital assets within 31 months of the receipt by the qualified opportunity zone business of the working capital assets.

Third, the qualified opportunity zone business must actually use the working capital assets in a manner that is substantially consistent with the statement and the 31-month schedule. With the COVID-19 pandemic, there may be projects which no longer make sense. For example, developing a new hotel in a dense urban area may not be the best use of a qualified opportunity zone business's investment dollars.

Unfortunately, the Treasury regulations are silent on the process, and the consequences, of a change in a qualified opportunity zone business's plans.

The Treasury regulations do not provide any explicit mechanism for a qualified opportunity zone business to change its statement, and there is a risk that a qualified opportunity zone business could fall out of the working capital safe harbor if either its statement changes or if its working capital assets are ultimately used in a manner that is inconsistent with its initial

statement.

Although there is no explicit guidance on whether a qualified opportunity zone business can change its statement and 31-month schedule, it seems reasonable that this would be permitted as long as there is a reasonable commercial justification for the change.

If one of the policy goals of the opportunity zone program is to encourage economic activity in opportunity zones, it makes sense to permit qualified opportunity zone businesses to pivot as needed to develop projects that will help to achieve that goal.

Recordkeeping will again be helpful here, so make sure that any changes to a qualified opportunity zone business's statement and 31-month schedule are documented with an explanation about why the change is happening. Any evidence showing external factors out of the qualified opportunity zone business's control should help to justify the changes.

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