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KPMG report: Timing considerations for QOF and QOF investors in light of COVID-19

There are a number of important timing and planning considerations with respect to existing and potential "qualified opportunity fund" (QOF) investments that may be affected by the current situation resulting from the coronavirus (COVID-19) pandemic.

The rules provide:

- Taxpayers who have triggered gains are "on the clock" to invest those gains.
  - Taxpayers generally have 180 days from the date a capital gain is triggered during which they can invest that gain, or a portion thereof, in a QOF and defer federal income tax on the gain.
- QOFs that formed and accepted capital contributions are on the clock to find investments.
  - QOFs that have received capital contributions from investors generally need to invest their capital in projects or in a "qualified opportunity zone business" (QOZB) within six months.
- QOFs and their QOZBs who have identified projects may be delayed in starting or continuing work.
  - QOZBs that are operating under working capital safe harbor plans generally have 31 months to deploy their capital in accord with their written working capital schedule.

Although the Treasury Department and IRS have not yet published guidance that addresses QOZ issues resulting from the ongoing COVID-19 crisis, the existing regulations may provide some helpful direction. Absent specifically applicable rules, taxpayers need to consider what can be gleaned from the existing framework and adopt some best practices that may prove beneficial later.

Let's consider each of the above situations on its own.

The time to invest a triggered gain

General rules

The opportunity zone rules generally require capital gains to be invested within 180 days of the date of the sale or exchange that resulted in the gain. This rule applies to individuals who trigger capital gains in their individual capacity. If a partnership triggers a capital gain (and does not itself elect to defer that gain), the partners that receive the capital gain as part of their distributive shares can elect to defer their respective gain amounts, or portions thereof, and they have a few options in terms of when their 180-day clock for investment will start.

The general rule is that a partner starts its 180-day clock on the last day of the partnership's tax year. Under the final regulations, a partner also has the option to begin its 180-day clock on the due date of the partnership's tax return without extensions. There is also a third option that partners may take advantage of in terms of their 180-day clock. When a partnership itself does not elect to defer a gain, the partners (or individual partner) may elect to start their 180-day clocks on the day that the partnership realized the gain. For taxpayers who receive capital gains passed through from certain pass-through entities other than partnerships, rules similar to those described above apply.

Planning considerations

Unfortunately, there is no relief currently available for taxpayers who have already triggered gains. Those taxpayers are on the clock. If the gains were triggered at a lower-tier entity, in order to maximize the time the taxpayer has to find a QOF investment and defer tax on the gain, the taxpayer needs to consider opting to start its 180-day investment clock on the latest possible date—i.e., the due date of the entity's tax return without extension. For gains triggered at the entity level in 2019, this date would be March 16, 2020, and therefore the electing taxpayers would have until September 11, 2020, to defer the gain by contributing cash to a QOF.

For taxpayers who are triggering capital gains in 2020, perhaps to get access to much-needed cash or merely as a result of selling positions in volatile capital markets, they need to be aware that **gross capital gain amounts are eligible for QOF investment**. Although many taxpayers may be in a net loss position for the year overall, tracking the dates and amounts of capital gain transactions can still be advisable in the event a QOF opportunity presents itself over the coming months.

Finally, although as noted, there is currently no relief or discussion of extending the time for rollover of gains into QOFs, taxpayers who were considering such investments may want to document their interest and any efforts at diligence or investigation of QOFs. Contemporaneous documentation could prove useful if there eventually is an extension of time for such investors.

The reasonable cause exception for QOF/QOZB testing failures

General rules

QOFs are required to maintain a certain level of investment in QOZ property (the 90% investment standard), and QOZBs are required to maintain a certain level of their tangible property as QOZ business property (the 70% tangible property standard). The 90% investment standard for QOFs is generally tested twice a year at six-month intervals, and compliance is evaluated based on the average of the percentages at those two dates. The 70% tangible property standard for QOZBs is generally tested at the end of the QOZB's tax year. In order to meet their 90% investment standard, many QOFs—as they approach their first testing date—will form QOZBs and push their capital down to the QOZBs. The QOZBs will then elect to use the so-called "working capital safe harbor," which generally gives the QOZBs up to 31 months per capital contribution (and potentially up to 62 months in total) to deploy the QOFs' capital to build their project or establish their new trade or business.

Planning considerations

QOFs and taxpayers are facing any number of challenges right now, but there are two different problematic scenarios that may be common among QOFs and/or QOZBs at the moment.

- First, there are QOFs that have taken in capital from investors and find a testing date approaching, but find themselves unable to identify a QOZ investment. This could be for a variety of reasons, from specific issues related to inability to get out and complete due diligence on a property, to the seizing up of debt markets or questions about the valuation of real estate and the market in general.

- Second, there are QOZBs that were formed and adopted working capital safe harbor plans that included procuring assets or executing deals that have subsequently fallen through. These are not situations in which a QOZB has already acquired an asset or property and started work but rather situations in which the target asset or property was not or could not be acquired

In both of these situations, the QOF runs the risk that it will fail its 90% investment standard. A QOF could fail because it cannot identify an investment and its percentage of QOZ property will be 0% (note, even if a QOF makes a good QOZ investment later in the year, a 0% at the first of its two semi-annual testing dates may result in a failure for the year). In addition, a QOF could fail because its QOZB, despite initially having a compliant working capital safe harbor plan, failed to maintain the schedule outlined in that plan because it could not procure assets or otherwise develop them according to the original plan.

For QOFs in these specific situations, or ones analogous, there may be relief available in the QOZ statute itself. Section 1400Z-2(f)(3) of the Code contains **a reasonable cause exception for QOFs that fail to maintain their 90% investment standard.** Reasonable cause is obviously not a bright-line standard, but given the unprecedented nature of the current economic situation, it may be that taxpayers could obtain relief for delays and interruptions during this time period. There is no specific procedure for applying for or obtaining reasonable cause relief for failure to maintain a QOF's investment standard, but prudent QOFs would want to maintain contemporaneous records of time and resources spent during this period and any efforts or interests in investments that did not ultimately pan out.

Tolling the working capital safe harbor period

General rules

For QOFs and QOZBs that have already made investments and elected to use the working capital safe harbor, there are two existing provisions in the final QOZ regulations that allow QOZBs to extend the 31-month safe harbor period to complete their development activities (bearing in mind that many QOZBs rely on "complementary safe harbors," in addition to relying on working capital safe harbor treatment to ignore cash for purposes of the 5% limitation on non-qualified financial property). If the working capital plan is delayed by "waiting for governmental action the application for which is complete," then the 31-month period is generally paused during such time. Also, if the QOZB is located within a QOZ within a federally declared disaster* then the QOZB may add up to an additional 24 months to its original 31-month plan.

*For these purposes, the QOZ regulations cross-reference section 165(i)(5)(A) of the Code which provides, "The term 'Federally declared disaster' means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act."

Planning considerations

For QOZBs that are in the midst of their working capital safe harbor period, the current situation may significantly affect their ability to complete projects within the required 31 months. In some cases, the delays may be attributable to waiting on governmental action, but in many cases, the delays may be caused by the overall economic situation. Under the existing QOZ rules, delays attributable to waiting on the government will clearly pause the 31-month period, but delays due to macroeconomic disruptions would not seem to be covered by the regulations. Nonetheless, regardless of the cause, taxpayers and their QOZBs need to keep contemporaneous records related to all delays during the current economic climate because relief may be provided at some point in the future and the requirements for such relief could include documentation of the causes.

In addition, QOZBs that are currently using the working capital safe harbor need to be aware of ongoing developments with respect to federal disaster relief. On March 13, 2020, the U.S. president issued an emergency declaration under the Stafford Act in response to the ongoing COVID-19 pandemic. While there are questions about whether this declaration itself is sufficient to trigger a federally declared disaster for purposes of section 165(i)(5)(A),* subsequent to that declaration, the president has approved disaster declarations for California, Washington, and New York (as of March 24, 2020). These declarations would appear sufficient to make these three states disaster areas for purposes of the QOZ regulations. Assuming so, then **QOZBs with projects in any of these states may be able to extend their existing working capital safe harbor periods for an additional 24 months**. If additional states or areas are declared disasters by the president, then the same extensions of time would appear to apply to QOZBs with projects within those areas.

The scope and application of disaster relief obviously remains in flux as events and the responses to them continue to evolve. At this time it is difficult to determine exactly how the QOZ regulations will interact with the current federal emergency and disaster declarations. It may be that any QOZB project in one of the states that is declared a disaster area will eventually be given an additional 24 months to complete its working capital plan. For the time being it appears that at least those projects that are currently underway in California, New York, and Washington may be entitled to the additional time.

*The declaration was of an "emergency" under section 501(b) of the Stafford Act, but goes on to state that, "the disaster is of such severity and magnitude nationwide that requests for a declaration of a major disaster as set forth in section 401(a) of the Stafford Act may be appropriate

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