



# What's News in Tax

Analysis that matters from Washington National Tax

## Qualified Opportunity Zone Rules as of June 2020— Checking In and Checking Up

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As with almost all current developments, the ongoing pandemic has significantly disrupted aspects of qualified opportunity zone (“QOZ”) planning and development. Fortunately for qualified opportunity funds (“QOFs”) and potential QOF investors, recent guidance from the IRS, as well as some corrective changes in the final QOZ regulations, has provided much-needed relief for the 2020 tax year and beyond.

This brief update focuses on the relief provided in Notice 2020-39 and how QOFs and QOF investors may maximize the potential flexibility allowed by this guidance.

### 1. Notice 2020-39

This notice provides five substantive relief measures:

- Extends to December 31, 2020, the 180-day period for many investors to defer tax on capital gains by investing in QOFs<sup>1</sup>
- Grants reasonable cause relief for a QOF's failure to satisfy the 90 percent investment standard in 2020

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<sup>1</sup> This notice modifies the extension previously provided under Notice 2020-23 (which gave taxpayers until July 15, 2020, to defer tax by making a QOF investment).

- Suspends the 30-month substantial improvement period for the balance of 2020 for QOFs or Qualified Opportunity Zone Businesses (“QOZBs”) that are developing or improving non-original use property under the rules provided by the QOZ statute
- Confirms that all QOZBs holding working capital assets covered by working capital safe harbors before the end of 2020 receive no more than an additional 24 months to expend the working capital assets (i.e., added to the original 31-month safe harbor period for these assets)
- Provides a QOF an additional 12 months (up to a total of 24 months) to reinvest proceeds of a disposition in QOZ property if the QOF’s original reinvestment period included January 20, 2020

The relevance of these provisions to QOF investors, existing QOFs, and existing QOZBs is discussed below.

## 2. QOF Investors

Under the standard QOF rules, investors have 180 days from realization to invest a capital gain in a QOF and thereby defer taxation on that gain. For gains that flow through from a pass-through entity, investors can start their 180-day clocks as late as the due date of the pass-through entity’s tax return (without extension). In 2020, that would have been March 15 for calendar-year pass-through entities.

What Notice 2020-39 provides is that for any investor with a 180-day investment period that ends on or after April 1, 2020, and before December 31, 2020, the end of the investor’s investment period is now December 31, 2020. Practically, this means that the following gains can be deferred if invested in a QOF as late as December 31, 2020:

- Gains of individuals (or corporations) realized between October 4, 2019, and July 4, 2020,<sup>2</sup> and
- Gains allocated from pass-through entities realized at any time during 2019.

The notice provides that this extended investment period is automatic, so investors do not need to apply for this relief. However, if an investor is interested in deferring a 2019 gain and potentially investing later in 2020, an important consideration is how to file the investor’s 2019 tax return. Under current rules, taxpayers will be required to file their 2019 tax returns prior to December 31, 2020, and Notice 2020-39 indicates that taxpayers will need to make their QOF deferral elections with timely filed returns. The question becomes: How should an investor properly file for deferral via a QOF investment that comes after the due date of its tax return? Unless and until the IRS provides some clarity on how taxpayers in this situation should file, there seem to be two choices:

- If a QOF investor intends to timely invest in a QOF by the end of 2020, the investor could treat the capital gain as being deferred when it files its 2019 tax return. To do this the investor may

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<sup>2</sup> The 180-day investment period for gains of individuals or corporations that are realized after July 4, 2020, does not end until after December 31, 2020—although these gains may also be invested in 2020, prior to the end of the investor’s 180-day period.

have to leave blank several of the required items on its Forms 8949 and 8997, e.g., the EIN of the QOF in which the investment was made and the date of the investment.<sup>3</sup> Furthermore, if by the end of 2020 the investor does not make a QOF investment, then presumably the investor would have to file an amended return and take into account the gain.<sup>4</sup>

- If a potential QOF investor does not take the approach above prior to filing its 2019 tax return, but then makes a QOF investment before the end of 2020, the taxpayer would have to file an amended return to defer the 2019 gain and presumably get a refund for the tax paid on the gain.

### 3. QOFs

QOFs are required to maintain a certain level of investment in QOZ property (the 90 percent investment standard). The 90 percent 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 intent of the 90 percent investment standard is to ensure that QOFs do not hold capital, while its investors benefit from deferral, without investing in QOZs. To meet their 90 percent investment standard, many QOFs, as they approach their first testing date, will form QOZBs and push their capital down to the QOZBs.

Notice 2020-39 provides that for a QOF whose (1) last day of the first six-month period of the tax year or (2) last day of the tax year falls within the period beginning on April 1, 2020, and ending on December 31, 2020, a failure of the 90 percent investment standard for the tax year of the QOF is due to reasonable cause under section 1400Z-2(f)(3) of the Code.<sup>5</sup> Practically, this means that QOFs are not subject to testing in 2020.<sup>6</sup>

For QOFs that had been anticipating pushing capital down to QOZBs or otherwise investing in QOZ property ahead of a June 30, 2020 testing date, this relief means that those investments are not necessary (although to be clear, it remains allowable). The relief provided in Notice 2020-39 recognizes that, through no fault of their own, many QOFs may not be able to invest in QOZ property during 2020. Practically, for any QOF formed in 2020, and even QOFs that first received capital contributions after July 2019,<sup>7</sup> the first relevant testing date will likely be June 30, 2021.

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<sup>3</sup> After the investor eventually makes its QOF investment and has the relevant details, the investor may consider filing a supplemental statement with the IRS, asking that the newly completed information be associated with its earlier-filed return, or the investor could file an amended return with the updated information. The compliance aspects are beyond the scope of this article. Taxpayers should consult with their tax preparers.

<sup>4</sup> Taxpayers also need to consider what will happen if they choose to take this approach and identify a QOF investment that absorbs some but not all of their deferred gain.

<sup>5</sup> Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

<sup>6</sup> Note that although QOFs will not be penalized for a failure of the 90 percent investment standard in 2020, QOFs that are in good standing and can pass their tests should not be discouraged from doing so and keeping their records up to date.

<sup>7</sup> For QOFs that first received capital contributions after July 2019, if they availed themselves of the regulatory provision that allows QOFs to exclude recently contributed capital at testing dates during the subsequent six months, the December 31,

QOFs do not have to apply for this relief or provide any documentation. QOFs do have to accurately complete Form 8996 and where the Form calls for a QOF to self-assess a penalty for a failure of the 90 percent investment standard, the QOF should place a “0” in Part IV, Line 8.<sup>8</sup>

One interesting implication of the relief provided by Notice 2020-39 appears to be that QOFs do not need to concern themselves with the types of assets they hold during 2020 (and likely through June 2021). Typically, QOFs have held contributed capital in cash and cash equivalents in order to access the favorable provisions in the regulations that allow QOFs to ignore recently contributed capital for purposes of the 90 percent test if the capital is held in short term cash and debt. By eliminating the penalty for failing to meet the 90 percent investment standard for 2020, Notice 2020-39 also eliminates the need for QOFs to restrict their investments (although, obviously the terms of investor agreements may limit what QOF sponsors can do with their capital prior to finding a QOZ investment).

#### 4. QOZBs

QOZBs are generally subject to a number of requirements in order to maintain their status. At the outset of a project, many QOZBs will elect to use the so-called “working capital safe harbor,” which generally gives the QOZBs up to 31 months to deploy the QOF’s capital to build their project or establish their new trade or business. The final QOZ regulations provide that if a QOZB is located in a QOZ within a federally declared disaster then the QOZB may receive not more than an additional 24 months to complete its working capital plan.

Notice 2020-39 provides that, as a result of the current federally declared disaster covering the entire country, all QOZBs with assets covered by a working capital safe harbor plans in place before December 31, 2020, receive “not more than an additional 24 months” to expend the working capital assets of the QOZB. This relief appears to confirm the reading of the final regulations that many had suggested, namely that all QOZBs with working capital safe harbors in place in 2020 have a 55-month safe harbor period, rather than 31-month safe harbor period. Further, Notice 2020-39 appears to confirm that the additional 24 months is compatible with the availability of two 31-month safe harbors under the regulations (for a total of 62 months), resulting in up to a maximum of 86 months to expend working capital assets, assuming all other requirements are met.

The most important consideration with respect to the extended working capital safe harbor may be its interaction with the QOF reasonable cause relief discussed above. As noted there, for many QOFs, the first relevant testing date will now be June 30, 2021, and so they might not choose to push down their working capital to a QOZB until just before that time. However, if a QOF chooses to wait until sometime

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2019 testing date was probably irrelevant and so the June 30, 2020 testing date was going to be their first important testing date. To take advantage of the rule and ignore recently contributed capital, QOFs must hold the capital in cash or cash equivalents through the testing date.

<sup>8</sup> Note that Notice 2020-39 and the relief it provides for QOFs regarding the 90 percent investment standard do not have any implications with respect to a QOF’s ability to access the QOZB cure provisions in section 1.1400Z2-1(d)(6). These provisions of the notice are directed to a QOF’s qualification whereas the cure provisions in the regulations relate specifically to a QOZB’s qualification as a QOZB.

in 2021 to form a QOZB and push down capital, the relief provided by Notice 2020-39 will have expired and, absent any further relief from the IRS, the 2021-funded QOZB may only have a 31-month safe harbor period.<sup>9</sup> To maximize time for development and preserve flexibility, it therefore may make sense for a QOF to form and fund its QOZB sometime in 2020, e.g., late December 2020. At the minimum, QOFs that choose to delay funding QOZBs this month, June 2020, because of the various relief provisions in Notice 2020-39 should be sure to revisit their QOZB planning prior to the end of 2020.

## 5. Conclusions and Takeaways

Notice 2020-39 is obviously a welcome relief for QOFs and investors confronting an uncertain investment picture, and fortunately it comes with sufficient lead time ahead of the important June 30, 2020 date that many QOFs had circled for QOZB decisions. So what if anything should existing QOFs be doing right now?

For most existing QOFs, delaying QOZB formation and investment for the time being may likely make sense. For those that have already formed and funded QOZBs, they now have an additional two years added to their working capital safe harbor period. One thing that the notice does not discuss is whether QOFs and/or QOZBs need to be active or doing anything in furtherance of their plans during these periods of delay. Given that the various relief measures are automatic, it does not appear to be the case. Nonetheless, to the extent existing QOFs or QOZBs are evaluating the impact of this relief on existing plans, in particular existing working capital safe harbor plans, it may make sense to take note of this recent grant of relief and incorporate it into any timelines as relevant. This could also be an opportunity to make an initial assessment as to whether forming a QOZB at the end of 2020, and thereby locking in the additional 24 months, makes sense as compared with waiting until June 2021, when the added time may no longer apply. All of this of course depending on the availability and viability of actual QOZ investments.

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<sup>9</sup> While Notice 2020-39 only provides certainty for QOZBs with working capital safe harbor plans in place in 2020, the QOZ regulations allow no more than an additional 24 months for any QOZBs operating in a federally declared disaster. Therefore, if the current pandemic-related national disaster declarations continue in effect into 2021, QOZBs formed and/or funded in 2021 may be granted the same additional 24 months of added time on their working capital safe harbor periods.