The Impact of the Coronavirus Crisis on Opportunity Zone Planning

Posted on Mar. 31, 2020

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Investors are generally scarce during periods of great economic uncertainty, and that seems to be especially so when the cause is a pandemic. No specific pandemic-related Opportunity Zone guidance is expected soon, but Treasury and possibly even Congress could turn to it once the public health crisis has subsided and tax considerations become more of a priority.

The uncertainty of the short term has chilled and even unraveled some Opportunity Zone transactions, but a turnaround is likely when the pandemic abates. "It's so early that it's hard to know exactly what's going to happen, but there will be opportunities like there are with any other dislocation in the market," said Jonathan Talansky of King & Spalding LLP.

When those opportunities might appear is of course still unknown, but "hopefully it will be around Memorial Day and not Labor Day, although obviously no one has visibility into the rapidly developing course of this health crisis," Talansky said. The timing issues have particular relevance for Opportunity Zone deals, because investors have 180 days from the date they received capital gains to reinvest them, and qualified opportunity funds and qualified Opportunity Zone businesses (QOZBs) must meet deadlines for reinvesting sale proceeds and using working capital. Tolling provisions in the final regulations can help blunt the impact of the timing requirements, but Treasury and the IRS might consider making changes that provide more clarification and relief.

What to Do Now

The immediate to-do list differs for investors, QOFs, and QOZBs. For investors who have capital gains to invest, the biggest question is whether the 180-day period in section 1400Z-2(a)(1)(A) for investing their gains in a QOF might be extended. The stock market decline began around February 21 and hit its lowest point so far on March 23. Gains from sales or exchanges on February 20 would need to be reinvested by August 18, which could make this summer a busy time for investments. But depending on the course of the pandemic in the United States, that timeline is still uncertain.

An extension of the 180-day reinvestment requirement would help encourage investments, said Jessica Millett of Duval & Stachenfeld LLP. Congress would likely need to act to change the statutory investment timeline because the authority to grant reasonable cause exceptions for a QOF's failure to meet its 90 percent asset test doesn't extend to that time requirement applicable to investors. Millett said a consideration for investors is whether the capital gains tax rate might be higher in 2026, when the deferred gains must be included in income. Congress could remove that concern by allowing taxpayers to lock in the current rate for any eligible gains in 2026. It could also decide whether to temporarily allow investments of other types of income in addition to capital gains.

Fund managers and QOF sponsors who were raising money before the outbreak should be patient because potential investors generally aren't ready to focus on investing now. The 10-year hold period for QOF investments makes them an even harder sell right now. But once physical safety is restored, investors will return, and plenty of those who sold capital assets early enough this year, or held them for long enough, will have gains to invest. That group will have 180 days to invest their gain in a QOF, which will make the period from this summer through September a time for ramped-up fundraising efforts, Millett said. "The job of fund managers who were raising funds suddenly became much harder in the short term, but it will potentially be much easier in a few months," Millett said. She added that fund managers should have all their fundraising materials ready to go so that they are prepared when investors start looking for opportunities.

There will also be investors who were planning to invest in Opportunity Zones and had earmarked but not yet sold capital assets for the investments who no longer have those gains available. Even investors in that situation might still have capital gains that can be tapped for Opportunity Zone investments, given the overall trend of the market before the pandemic.

Reasonable Cause

Millett said QOFs that had raised cash and were about to invest it just before their deals fell through should document everything. "Keep track of the correspondence about when the deal died and how it happened, when you were supposed to close the deal, and your efforts to find another investment in the interim, because all of that will go into the reasonable cause exception," she said.

Under section 1400Z-2(f)(3), a QOF may avoid a penalty for failing to meet the 90 percent investment standard under subsection (d)(1) if it can convince the IRS that the failure was attributable to reasonable cause. In the preamble to the final regulations, Treasury addressed a comment that had asked whether the 90 percent qualified Opportunity Zone property holding period should be tolled because of circumstances beyond the control of the QOF or the QOZB. Treasury said the reasonable cause defense was "appropriate recourse" for handling circumstances beyond the QOF's control.

The preamble explained that Treasury and the IRS didn't want to adopt the recommendations that the government provide a non-exhaustive list of circumstances that would constitute reasonable cause or a definition including circumstances that "are outside the QOF's control to deploy capital into qualifying investments." Instead, the preamble pointed to the general standards on reasonable cause in the Internal Revenue Manual, but promised that Treasury and the IRS "will consider whether further guidance specific to the penalty under section 1400Z-2(f)(1) is necessary in the future."

The time for revisiting the need for specific guidance may come sooner than the government anticipated when the final regulations were published. The IRM explains that reasonable cause requires an examination of the totality of the facts and circumstances in each situation, and that relief is "generally granted when the taxpayer exercised ordinary business care and prudence."

Depending on the number of requests for reasonable cause relief that may be submitted to the IRS, the government might consider creating a time-limited exception to the standard reasonable cause procedure to allow QOFs that fail the 90 percent asset test on a testing date in 2020 to automatically qualify for reasonable cause relief, Millett suggested.

QOZB Relief

The uncertainty right now might hit QOZBs especially hard, because they must meet both the QOZB property requirements and the trade or business requirements to qualify as a QOZB. That could be difficult to do, depending on the QOZB's circumstances attributable to the pandemic. For example, if a QOZB is required to have employees work from home for an extended period, it might not have 50 percent of its gross income derived from the active conduct of the trade or business in the Opportunity Zone.

Working Capital Safe Harbor

Can a QOZB toll the working capital safe harbor beyond the two consecutive 31-month periods? For now, that depends on the state where it's located and how Treasury decides to handle the sudden profusion of federal disaster areas. The regulation writers included rules that gave some relief in the event of a disaster declaration, but they most likely never saw a global pandemic coming, so it's unclear how that might play out.

Reg. section 1.1400Z2(d)-1(d)(3)(v)(D) allows QOZBs up to an extra 24 months past the 31-month safe harbor to use their working capital assets if the project otherwise meets the safe harbor requirements and is located within a qualified Opportunity Zone that is designated as part of a federally declared disaster area. A federally declared disaster area is declared by the president under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. (Prior analysis.) Governors must request that their states, or portions of them, be declared major disaster areas. The qualifications in the regulation – that this relief "may" be permitted and that the relief will be granted "up to an additional 24 months"— suggest that Treasury had something like an application process in mind.

Reg. section 1.1400Z2(f)-1(b)(2) gives QOFs up to 12 more months to reinvest the return of capital from investments in qualified Opportunity Zone property and proceeds from the sale of that property for delays caused by a federally declared natural disaster, but it requires QOFs to invest proceeds as originally planned before the disaster.

The preamble includes an example in which a QOF can't invest in a particular piece of QOZB property because the property is in a federally declared disaster area, but explains that the QOF must find similar property located in the same Opportunity Zone to invest in. Note that the regulation requires the delay to be "due to a Federally declared disaster," and that the "may receive up to an additional 12 months" language suggests that the relief isn't necessarily automatic.

Treasury might find it expedient to grant blanket extensions under both those regs for now. That could probably be done through a revenue procedure. It's unlikely that the regulation writers envisioned a pandemic that would affect the entire nation and result in a large part of the IRS and many tax practitioners sheltering in place when they inserted the language suggesting that QOZBs and QOFs would need to apply for an extension. Streamlining that process seems sensible, because a QOZB or QOF doesn’t gain a windfall by getting 24 extra months to spend working capital or 12 extra months to reinvest sale proceeds.

Even if Treasury grants automatic extensions, QOZBs and QOFs still must meet the geographic requirement. The Federal Emergency Management Agency administers the federal disaster assistance programs and maintains the list of declared major disaster areas. As of March 30, the states that have been declared major disaster areas because of the COVID-19 pandemic were New York, Washington, California, Iowa, Louisiana, Florida, Texas, North Carolina, New Jersey, Illinois, Missouri, Maryland, South Carolina, Michigan, Kentucky, Massachusetts, Colorado, Oregon, Connecticut, Georgia, Kansas, and Alabama. Washington, D.C.; Guam; and Puerto Rico have also received major disaster area declarations. For QOZBs and QOFs in those states and territories, the final rules therefore allow for more time to use working capital assets and reinvest proceeds from return of capital and sales of qualified Opportunity Zone property.