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## Covid Relief Extended for Qualified Opportunity Funds and Investors

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On January 19, 2021, the IRS released Notice 2021-10 (the “Notice”), which expands and extends previous relief granted under Notice 2020-39 to Qualified Opportunity Funds (QOFs) and their investors in response to the ongoing Covid-19 pandemic. While the pandemic has disrupted aspects of the Qualified Opportunity Zone (QOZ) program including capital deployment, planning and development, QOFs and interested QOF investors were able to rely on much-needed relief for the 2020 tax year based on Notice 2020-39. Notice 2021-10 amplifies that earlier guidance.<sup>1</sup>

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<sup>1</sup> A full discussion of the requirements for gain deferral and exclusion under the QOZ program is beyond the scope of this article. We highlight in this section only those requirements affected by Notice 2021-10. For a more detailed discussion of the QOZ benefits and requirements, please see, *KPMG Report: Analysis and Observations about Final Regulations and Future of Opportunity Zone Investments*, <https://assets.kpmg/content/dam/kpmg/us/pdf/2020/01/tnf-kpmg-report-opportunity-zones-jan23->

## BACKGROUND

The QOZ program was introduced as part of the 2017 Tax Cuts and Jobs Act (TCJA).<sup>2</sup> Under the QOZ regime, a taxpayer who sells property to an unrelated person in a transaction that generates capital gains, may defer taxation on those gains (or a portion of the gains) by investing an amount equal to those gains (or a portion of the gains) in a QOF within 180 days of the transaction giving rise to the gains.<sup>3</sup> The QOF then must invest the amounts received in Qualified Opportunity Zone property (QOZ property). On an annual basis, a QOF is required to establish that 90% of its assets are QOZ property (the 90% investment standard).<sup>4</sup> Failure to meet the 90% investment standard may subject the QOF to penalties, unless it is shown that the failure is due to reasonable cause.<sup>5</sup>

In general, QOZ property includes QOZ stock, a QOZ partnership interest, and QOZ business property.<sup>6</sup> Various requirements must be satisfied for property to qualify as QOZ property. Of particular relevance to the provided relief, for property to qualify as QOZ business property, the property must be “original use” property or undergo substantial improvements within a 30-month period beginning after the date of acquisition.<sup>7</sup>

Similarly, to qualify as QOZ stock or a QOZ partnership interest, the corporation or partnership issuing such stock or partnership interest must be engaged in a Qualified Opportunity Zone Business (a QOZB).<sup>8</sup> One of the requirements to be engaged in a QOZB is that less than five percent of the entity’s aggregate unadjusted basis in assets be attributable to nonqualified financial property (e.g., certain financial or debt in-

2020.pdf (Jan. 23, 2020).

<sup>2</sup> Pub. L. No. 115-97.

<sup>3</sup> §1400Z-2(a). All section references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

<sup>4</sup> §1400Z-2(d)(1).

<sup>5</sup> §1400Z-2(f).

<sup>6</sup> §1400Z-2(d)(2)(A).

<sup>7</sup> §1400Z-2(d)(2)(D).

<sup>8</sup> §1400Z-2(d)(2)(B), §1400Z-2(d)(2)(C).

struments, stock, partnership interests).<sup>9</sup> For this purpose, term “nonqualified financial property” does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

The §1400Z-2 regulations provide certain QOZBs with a safe harbor for treating an amount of working capital as reasonable for purposes of the definition of nonqualified financial property if certain requirements are met (the working capital safe harbor or WCSH).<sup>10</sup> One such requirement is that the QOZB have a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets.<sup>11</sup> A QOZB may extend the WCSH period to a maximum 62-month period if certain additional requirements are met.<sup>12</sup> If the QOZB is located within a federally declared disaster area, the WCSH period may be further extended by no more than 24 months.<sup>13</sup>

Finally, during its investment period, a QOF may find it necessary to dispose of its ownership in the QOZ property. To the extent the QOF reinvests the sale proceeds from such disposition in another QOZ property within 12 months from the date of the disposition, the proceeds are treated as QOZ property for purposes of the 90% investment standard.<sup>14</sup>

## EXPANDED RELIEF IN NOTICE 2021-10

Notice 2021-10 provides five substantive relief measures for QOFs and their investors. In particular, Notice 2021-10:

1. Extends to March 31, 2021, the 180-day period for many investors to defer tax on capital gains by investing in QOFs;<sup>15</sup>
2. Tolls the 30-month substantial improvement period for the time period between April 1, 2020, and March 31, 2021, for QOFs or QOZBs that are developing or improving non-original use

<sup>9</sup> §1400Z-2(d)(3)(A). Nonqualified financial property is defined in §1397C(e).

<sup>10</sup> Reg. §1.1400Z2(d)-1(d)(3)(v).

<sup>11</sup> Reg. §1.1400Z2(d)-1(d)(3)(v)(B).

<sup>12</sup> Reg. §1.1400Z2(d)-1(d)(3)(v)(F).

<sup>13</sup> Reg. §1.1400Z2(d)-1(d)(3)(v)(D).

<sup>14</sup> Reg. §1.1400Z2(f)-1(b)(1).

<sup>15</sup> The Notice modifies the extension previously provided under Notice 2020-39 which gave taxpayers until December 31, 2020, to defer tax by making a QOF investment.

property under the substantial improvement safe harbor provided by the QOZ statute;<sup>16</sup>

3. Grants reasonable cause relief to certain QOFs for a failure to satisfy the 90% investment standard in 2021;

4. Confirms that all QOZBs holding working capital assets that are covered by WCSH plans that are in place before June 30, 2021, may receive an additional 24 months to expend the working capital assets (i.e., added to the original 31-month safe harbor period for such assets); and

5. Provides a QOF an additional 12 months (up to a total of 24 months) to reinvest proceeds from a disposition of QOZ property if the QOF's original reinvestment period included June 30, 2020, without treating the sale proceeds as non-QOZ property for purposes of the 90% investment standard.

The relevance of these provisions to (i) QOF investors, (ii) existing QOFs, and (iii) existing QOZBs is discussed below.

## QOF Investors

As discussed above, to defer the recognition of capital gain under the QOZ program, investors have 180 days from gain realization to invest an amount equal to the gain in a QOF. For gains that flow through to an investor from a pass-through entity (e.g., a partnership), investors can start their 180-day clocks as late as the due date of such pass-through entity's tax return (without extension). For example, for capital gains allocated to a partner from a calendar year partnership in 2019, the partner could have started its 180-day clock from the allocated capital gains as late as March 15, 2020. In that case, the partner's 180-day investment period would have ended on September 11, 2020.

Under Notice 2021-10, for any investor with a 180-day investment period that ends on or after April 1, 2020, and before March 31, 2021, the end of such investor's investment period is now March 31, 2021. Practically, this means that the following gains can be deferred if invested in a QOF as late as March 31, 2021:

- Gains of individuals or corporations realized between October 4, 2019 and October 2, 2020,<sup>17</sup> and

<sup>16</sup> The Notice extends the suspension of the improvement period which Notice 2020-39 had tolled through December 31, 2020.

<sup>17</sup> The 180-day investment period for gains of individuals or corporations that are realized after October 2, 2020, does not end

- Gains allocated from pass-through entities realized at any time during 2019.<sup>18</sup>

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, an important consideration is how to report the deferral of the gain given the investor will likely have already filed its tax return for the 2019 year. Notice 2021-10 indicates that taxpayers will need to file amended returns in order to defer the gain.

## QOFs

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.<sup>19</sup> The intent of the 90% investment standard is to ensure that QOFs do not hold capital, while its investors benefit from deferral, without investing in QOZs. In order to meet the 90% investment standard, many QOFs, as they approach their first testing date, will form QOZBs and push their capital down to the QOZBs.

Notice 2021-10 provides that for a QOF whose (i) last day of the first six-month period of the taxable year *or* (ii) last day of the taxable year falls within the period beginning on April 1, 2020, and ending on June 30, 2021, a failure of the 90% investment standard for that taxable year of the QOF is due to reasonable cause under §1400Z-2(f)(3).<sup>20</sup> Practically, this means that most QOFs will not be subject to penalties in 2021 (e.g., calendar year taxpayers are not subject to penalties for all of 2021).<sup>21</sup>

For QOFs that had been anticipating pushing capital down to QOZBs or otherwise investing in QOZ property ahead of the June 30, 2021, this relief means that such investment is not necessary (although to be clear, it remains allowable). Practically, for any QOF formed in 2020, and even QOFs that first received capital contributions after July 2019, the first relevant testing date will likely be June 30, 2022.

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until after March 31, 2021 – although such gains may also be invested prior to the end of the investor’s 180-day period.

<sup>18</sup> Gains from pass-through entities realized in 2020 will generally have 180-day periods that extend out beyond March 31, 2021.

<sup>19</sup> §1400Z-2(d)(1).

<sup>20</sup> Note that although QOFs may not be penalized for a failure of the 90% investment standard in 2020 or 2021, 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>21</sup> Note that QOFs that are formed after January 2021 will not qualify for this relief because the last day of the first six-month period of their taxable years will be after June 30, 2021. Also, under Notice 2020-39, QOFs were already provided similar relief for 2020.

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 to satisfy the 90% investment standard, the QOF should place a “0” in Part IV, Line 8 (Penalty).

One interesting implication of the relief provided by Notice 2020-39, and extended by Notice 2021-10, appears to be that QOFs do not need to concern themselves with the types of assets they hold through at least the end of 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% test if such capital is held in short term cash and debt. By eliminating the penalty for failing to meet the 90% investment standard for 2020 and 2021, these Notices also eliminate the need for QOFs to restrict their investments (although, the terms of investor agreements may limit what QOF sponsors can do with their capital prior to finding a QOZ investment).

## QOZBs

QOZBs are generally subject to a number of requirements in order to maintain their status. One requirement discussed earlier is the five percent limit on nonqualified financial property. At the outset of a project, many QOZBs will elect to use the 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. 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 2021-10 provides that, as a result of the current federally declared disaster for the Covid-19 pandemic covering the entire country, all QOZBs with assets covered by a working capital safe harbor plan in place before June 30, 2021, receive “not more than an additional 24 months” to expend the working capital assets of the QOZB. This relief means that all QOZBs with working capital safe harbors in place before June 30, 2021, can have a 55-month safe harbor period, rather than 31-month safe harbor period. Further, Notice 2021-10 reconfirms 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 how it impacts the overall required timing of investment

when considered in conjunction with the relief from the 90% investment standard discussed above. For many QOFs, the first relevant testing date will now be June 30, 2022, and so a QOF 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 after June 30, 2021, to form a QOZB and push down capital, the relief provided by Notice 2021-10 will have expired and, absent any further relief from the IRS, the QOZB may only have a 31-month safe harbor period. In order to maximize time for development and preserve flexibility, it therefore may make sense for a QOF to form and fund its QOZB sometime in the first half of 2021. At a minimum, QOFs that choose to delay funding QOZBs because of the relief provisions in Notice 2021-10 should be sure to revisit their QOZB planning prior to the end of June 2021.

## **CONCLUSIONS AND TAKEAWAYS**

For most existing QOFs, delaying QOZB formation and investment for the time being will likely make

sense. For those that have already formed and funded QOZBs, it is safe to assume 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 amend or at least 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 by June 2021, and thereby locking in the additional 24 months, makes sense as compared with waiting. All of this of course depends on the availability and viability of actual QOZ investments.