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IRS Provides OZ Relief for Some, But Not All

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In a series of related actions by the IRS designed to provide relief for taxpayers affected by the COVID-19 pandemic, the IRS, under its Code Section 7508A authority, issued Notice 2020-23 (Notice). The Notice amplifies, clarifies and extends prior federal tax relief that postponed certain filing and payment obligations from April 15, 2020 to July 15, 2020. Among the extensions afforded by the Notice is a postponement of the 180-day timeline for taxpayers considering investments in qualified opportunity funds (QOFs).

Under Section 1400Z-2(a)(1)(A) of the Internal Revenue Code, taxpayers have 180 days to invest eligible capital gains into a QOF to qualify for the benefits of the federal qualified opportunity zone tax program (OZ Program). Those benefits can include tax deferral, tax forgiveness and tax avoidance. The commencement of the 180-day period depends largely on the source of the eligible capital gain and the transaction generating it. If an individual taxpayer, for instance, sells investment property, his or her 180-day period begins on the date of sale. If, however, a taxpayer is allocated eligible capital gains from a partnership's sale of capital assets, the taxpayer can elect to start its 180-day period on the date of the partnership's sale transaction, the last day of the partnership's taxable year or the due date for the partnership's tax return, without extensions. While an in-depth review of the various 180-day periods under the OZ Program is beyond the scope of this alert, it is worth noting that the determination of a taxpayer's 180-day period is dependent upon specific facts and circumstances, and taxpayers should consult their tax advisors in making such a determination.

The Notice provides relief from this 180-day period for taxpayers that would otherwise face expiring QOF investment time periods between April 1, 2020 and July 14, 2020. Taxpayer's with "Specified Time-Sensitive Actions" due to be performed on or after April 1, 2020 and before July 15, 2020 are considered "Affected Taxpayers" for purposes of the Notice's relief provisions, and the Notice specifically includes the 180-day period for QOF investments under Code Section 1400Z-2(a)(1)(A) as a Specified Time-Sensitive Action. Pursuant to the Notice, the new deadline for those Affected Taxpayers to make QOF investments would be July 15, 2020.

By way of example, assume that an individual taxpayer sold her business on November 27, 2019 and recognized significant capital gain on the sale. She intended to defer a portion of the gain by investing it in a QOF and electing deferral under Code Section 1400Z-2(a)(1)(A). Absent the Notice, her 180-day period would have expired on May 24, 2020. Under the Notice, though, her new deadline for investing in a QOF is July 15, 2020, giving her an extra 51 days to make a QOF investment.

While the extension of the 180-day period for QOF investments is advantageous for taxpayers looking to take advantage of the benefits of the OZ Program, it provides no relief to QOFs with impending qualified opportunity zone property (OZ Property) testing dates. Many taxpayers made QOF investments on or before December 31, 2019 to take advantage of the full 15% tax forgiveness for eligible capital gains invested in QOFs and held for seven years prior to December 31, 2026. For most of those QOFs, the first applicable OZ Property testing date is June 30, 2020. To comply with the OZ Program and avoid penalties, a QOF would need to deploy nearly all its cash investments in OZ Property. With shelter-in-place orders in effect for several more weeks (or months, as in the case of Virginia's order, which is currently in effect through June 10, 2020), it will be extremely challenging for QOFs with undeployed capital to make OZ Property investments by the end of June.

For the benefit of taxpayers that have already invested in QOFs, the IRS should consider using its Code Section 7508A authority to postpone any QOF testing dates occurring after April 1, 2020 and before December 31, 2020. In addition, the IRS in guidance should declare the COVID-19 pandemic to be a reasonable cause for a QOF's failure to satisfy OZ Property tests under Code Section 1400Z-2(f)(3).

Most, if not all, real estate developments and corporate transactions have experienced some COVID-19 interruption, making it difficult, if not impossible, for QOFs to find available investment opportunities. QOFs should be given meaningful time to find and diligence investments in OZ Property. Absent the benefit of more time, many QOFs may opt to decertify, leaving critical projects in qualified opportunity zones with fewer and less-motivated investors.

Williams Mullen is continuing to monitor guidance issued by the IRS with respect to the OZ Program. If you have any questions, do not hesitate to contact us.

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