Officials Play Coy on Opportunity Fund Decertification Guidance

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By Jonathan Curry

IRS officials declined to confirm whether the IRS would soon issue instructions on how qualified opportunity funds can give up their special status, but practitioners say it's a done deal.

The tax benefits of investing in qualified opportunity funds (QOFs) are well established, but obtaining those benefits is dependent on maintaining compliance with the program's guardrails, subject to tax penalties. Sometimes, it's just not worth it, according to panelists at the May 5 American Bar Association Section of Taxation meeting.

One of the requirements for QOF status is that at least 90 percent of the assets in the fund must be qualified Opportunity Zone property, a determination made by testing the assets twice a year and then averaging the percentage of those two dates. QOF status is straightforwardly determined through self-certification by completing Form 8996, but the process for decertification remains murky.

QOFs that fail to meet that 90 percent threshold pay a tax penalty based upon the magnitude of that failure, unless a reasonable cause exception is granted, though that's not clearly defined, explained Nickolas Gianou of Skadden, Arps, Slate, Meagher & Flom LLP.

"So maybe you have an [Opportunity Zone] fund, and you had amazing plans. And you know what? Things change. This is real estate, and things take time and the market changes and whatnot," said Kate Kraus of Allen Matkins Leck Gamble Mallory & Natsis LLP. "So maybe you want to terminate your status as an Opportunity Zone fund. . . . I think we should be getting guidance."

IRS officials present at the panel declined to comment on whether any such guidance was forthcoming, but they acknowledged that reg. section 1.1400Z2(d)-1(a)(3) states that self-decertification must take place in a manner prescribed by the IRS in "forms or instructions or in publications or guidance."

Kraus later told *Tax Notes* more emphatically: "There will be guidance," an assurance that she said is based on her prior conversations with officials.

"There has to be something that tells people how to do it," Kraus said. "Because right now, it's like, you stand up in front of the IRS, wave a white flag, and say, 'I surrender.' There must be a way to do it."

Round and Round

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Another area of ambiguity is what happens to investors if a QOF falls short of the 90 percent target.

"One of the questions I struggled with a lot is, if you fail the 90 percent test, are there any other consequences besides the penalty tax?" Gianou said. The consequences for QOFs are direct, but it's unclear what happens to the tax benefits claimed by the initial investors, he said.

According to Gianou, "There's a bit of circularity in the statute" in that the 90 percent test is part of the definition of a QOF, which suggests that if you don't meet that test, it's not a QOF, and you don't get the benefits if you aren't invested in a QOF. On the other hand, "the penalty tax applies, literally, to a QOF that fails the 90 percent test," he added.

Dominic DiMattia of the IRS Office of Associate Chief Counsel (Income Tax and Accounting) responded by pointing to the antiabuse authority described in Opportunity Zone regulations.

DiMattia noted that an example in the regs describes investors who formed an entity that self-certified as a QOF, but they never really intended for it to invest in qualified property. If, after 10 years of the QOF wrongly self-certifying, the investors sell their interests in the QOF and make the basis step-up election, then the IRS will "recast and recharacterize" that transaction so that the investors are no longer eligible for either deferral or the basis step-up.

"I think that's something important to be aware of," DiMattia said.

Gianou pointed out that the antiabuse rule also contains an example in which an investor acted in good faith but failed the test for reasonable reasons, but there's still ambiguity on what would qualify as a good reason.

In the meantime, a best practice would be for investors to ensure that, at least in the first year, the QOF meets the 90 percent threshold to show good intent, Gianou said.

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