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Insight

New Opportunity Zone Tax Rules Create Red Tape for Businesses

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There's been bipartisan interest in extracting more data from qualified opportunity funds and their subsidiaries, qualified opportunity zone businesses. To address this, the 2025 tax law added tax code Section 6039K, requiring funds to file annual information returns, and Section 6039L, requiring businesses to give their fund investors a written statement with information they need to file their returns.

I fear the new rules may be overbroad. There are lots of "accidental" qualified opportunity zone businesses out there (having the status without knowing it), and a few "zombie" qualified opportunity funds (having the status without disclosing it). If you're the lawyer for an accidental business, you might worry that your client might unwittingly accept investment from a zombie fund and take on a reporting obligation.

Out of caution, corporate lawyers — even those with no connection to the opportunity zone program — may feel compelled to update their subscription agreements to demand a representation and warranty every time an entity in an opportunity zone takes on new investors. To spare us this needless paperwork, the Treasury Department should keep the reporting burden solely on the funds, as it's done without complaint until now.

The problem arises because it's so easy to become a qualified opportunity zone business. Though not widely appreciated, even businesses with no intention of participating in the opportunity zone program can qualify.

A qualified opportunity zone business can't appear on a prohibited list such as a racetrack, under Section 1400Z-2(d)(3)(A); at least 50% of its gross income must be earned within an opportunity zone; at least 70% of its tangible property must be bought from an unrelated party after 2017 and used in the zone; at least 40% of its intangibles must be used in the active conduct of the business; and no more than 5% of assets can be cash or similar property.

Notice that business status requires no election or show of interest to qualify for opportunity zone benefits. As a result, many businesses are qualified without knowing it. Imagine a venture that uses investors' cash to buy land in an area that happens to be in an opportunity zone, then borrows to construct a building in a short timeframe. It's probably a qualified business.

By itself, qualified business status doesn't trigger a reporting obligation. The business must be a tax partnership or corporation, in which a qualified opportunity fund invested cash no earlier than 2018.

The one requirement that isn't likely to occur unwittingly is that the investor be a qualified fund. Well-managed funds identify themselves to their qualified businesses, because they want those businesses to avoid incurring penalties.

Still, I envision two scenarios where a QOF might fail to disclose its QOF status. First, some funds choose to hold some non-qualifying property. When shopping for non-qualifying property, a fund might not feel the need to disclose its status, because it doesn't think it's relevant.

Second, the fund manager simply could have messed up. Perhaps someone elected to be a qualified fund in 2019, changed their mind in 2020, and forgot about it. Or maybe they meant to "self-decertify," gave up because the IRS never created a self-decertification procedure, and just stopped filing Form 8996.

You might find it preposterous that people could make these mistakes. But it's a big country, and there is no telling what some people will do. Bottom line: There really are qualified opportunity funds that aren't obviously qualified.

Most of us will never get bitten by a zombie opportunity fund. If we do, it might not seem so bad — the business penalty for failing to furnish the required statement starts at $340 and can be waived if there's reasonable cause and not willful neglect.

There's still reason to worry. If you fail to furnish the form, you can't truthfully attest that you're in compliance with all your tax reporting obligations. And if the IRS decides that the failure was intentional (that is, if the revenue agent doesn't believe it was an accident), the penalty can reach 10% times the "aggregate amount of the items that are required to be reported correctly."

This would be disastrous if the IRS applied the 10% to the "value of tangible property held by such corporation or partnership." While I admit that these are extreme assumptions, corporate lawyers might prefer to be safe than sorry.

My concern is that the existence of this uncertainty could cause numerous lawyers to undertake a small amount of extra diligence and paperwork — and that will add up. I envision that whenever a business entity (tax-partnership or corporation) seeks a cash investment, it will ask whether it meets the qualified opportunity zone business tests above. If so, it would require new investors to affirm that they haven't elected, and won't elect, to be a qualified opportunity fund. This warranty becomes just another piece of needless boilerplate.

To avoid this waste, the Treasury Department should keep the reporting burden where it's been until now — exclusively on qualified opportunity funds. We know this would work, because it has worked with Form 8996 for nearly a decade. Under the instructions to Form 8996, the IRS holds such funds responsible to ensure that the info obtained from qualified businesses is "sufficient" for the fund to rely on.

Most qualified opportunity funds achieve this because they directly manage their related businesses. The rest have enough clout to twist their arms. Let's stick with what works and not add an extra layer of unnecessary penalties that could potentially burden unrelated deals.

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