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# The Opportunity Zone Program – More Than Just a Real Estate Tool

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As we enter into the third year of the federal Qualified Opportunity Zone (QOZ) program we have a much clearer picture of how taxpayers are using this flexible and impactful program as a result of several hundred pages of Proposed Regulations, Final Regulations released in late December 2019,[1] an IRS FAQ, and other taxpayer guidance.[2]

While the initial Opportunity Zone (OZ) statute and first set of Treasury regulations focused primarily on real estate projects as re-investment options, the second and final regulations clarified that operating businesses are also appropriate re-investments for deferred gain.

Not surprisingly, the vast majority of early Qualified Opportunity Funds (QOFs) formed thus far are focused solely on real estate projects. As regulatory guidance has been finalized and investors and advisors have grasped the full power and flexibility of the OZ program, private investors, private equity firms and venture capital firms have come to realize that using the OZ program for operating businesses may yield even greater long-term benefits than real estate investments — for investors as well as OZ communities.

## UTILIZING THE OZ PROGRAM FOR ACTIVE BUSINESSES

Both the QOF architects and the Trump Administration view the use of the OZ program as a valuable tax and economic development tool for operating businesses for the following reasons:[3]

- Increase overall commerce in OZ census tracts and adjacent neighborhoods;
- Increase employment and workforce training within OZ communities;
- Develop affordable/attainable/workforce housing in OZ communities;
- Reduce poverty levels within OZ communities;
- Accelerate long-term business growth; and
- Modernize local infrastructure.

Compared to real estate projects, operating business investments offer the following advantages:

- Less (or non-existent) entitlements;
- Less capital outlay;
- Arguably less risk;
- Quicker path to revenue generation;
- Ability to alter business plan;
- Mobility; and
- Potential for a higher multiple upon exit.

As a result of these incremental benefits, serial entrepreneurs and investors with connections to successful business operators should consider operating businesses as an highly attractive OZ business investment.

The regulations also provided more liberal reinvestment periods and other more flexible provisions as

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[1] T.D. 9889, 85 Fed. Reg. 1866 (Jan. 13, 2020).

[2] The Opportunity Zone Frequently Asked Questions is available at https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

[3] *See SoLa Impact Announces "The Beehive": The Nation's First Campus for Opportunity Zone Businesses*, available at https://www.solaimpact.com/thebeehive. *See also* Matthew Rothstein, *Real Estate Is Not The Heart Of The Opportunity Zone Program,* BISNOW (June 30, 2019), available at https://www.bisnow.com/national/news/opportunity-zones/opportunity-zones-operating-business-investment-focus-treasury-99674.

compared to real estate projects – now allowing up to 62-months to re-invest the Qualified Opportunity Zone Business (QOZB) funds.[4]

The following analysis will address these issues and compare and contrast the various ways an OZ investor might acquire an operating business within an QOZB. We will analyze the three general ways in order of easiest to most complex.

## RETURN ON INVESTMENT (ROI) EXAMPLES

A real estate investment's ROI will primarily be tied to real estate inflation in that geographic region with additional increases related to developer's profit for ground-up builds. Operating business valuations; however are generally tied to their earnings history (i.e., EBITDA multiple).

As an example, a $1,000,000 QOF real estate investment that is improved by another $600,000 loan, would appreciate to approximately $4,100,000 assuming a 10% compounded annual appreciation – a rate most would consider a home run for a real estate investment. This would result in an approximate $2,500,000 ($4,100,000 - $1,600,000) tax-free return to the investors if held for 10 years. Of course there would be earnings and depreciation occurring during the 10-year holding period which would adjust these figures.

Alternatively, if the investors choose to invest in, or start-up, a QOZB, they can start with the same $1,000,000 of gain deferral and borrow $600,000 for expansion/ operating capital. If the company is generating EBITDA of $500,000 after 10 years, a valuation at a seven multiple of earnings, would yield a sales price of $3,500,000 (before considering their net cash position) and a tax-free gain of approximately $1,900,000 ($3,500,000 - $1,600,000). Assuming the business accumulated net cash from operations of another million dollars there would be a total after-tax ROI of approximately $2,900,000 – larger than the real estate ROI.

It is important to note that even though the debt portion of QOF/QOZB financing is not eligible for the five and seven-year tax "step-ups," the ultimate tax exemption after the 10-year hold applies to both the equity and debt portions of the investment. Thus, leverage is your friend in the land of OZ.

[4] Reg. §1.1400Z(2)-2(d)(3)(v)(F). 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.

## OVERVIEW OF STATUTORY/ REGULATORY REQUIREMENTS FOR QOZB(S)

The core requirements for a business to qualify as a QOZB include the following statutory requirements:

1) At least 70% of the QOZB's assets must be QOZB Business Property used in primarily in OZ census tracts;[5]

2) At least 40% of all QOZB intangibles must be used in OZ census tracts;[6] and

3) At least 50% of the QOZB income must be associated be OZ-sourced income, determined under four "safe harbor" sets of rules contained in the regulations.[7]

There is no minimum amount required to invest in an operating business, and taxpayers can invest both qualified deferred gain and after-tax money into the business; however, only the qualified deferred gains invested into the QOF/QOZB are eligible for the various OZ tax benefits.

There are three general ways that OZ investors can get involved with an operating business which are summarized below.

### Establishing a New Business Within an OZ Census Tract

Establishing a new business (or starting a new division which offers a new product or service) within a single or multiple OZ census tracts is the most straightforward way to qualify an operating business under the I.R.C. and Treasury regulations.

The reason that a new start-up business is the cleanest way to meet the OZ qualifications is that the tangible property acquired for use in the new business will generally be treated as an eligible Qualified Op-

[5] Reg. §1.1400Z2(d)-1(d)(4).

[6] §1400Z-2(d)(3)(A)(ii) (reference to §1397C(b)(4)); Reg. §1.1400Z2(d)-1(d)(3)(ii).

[7] §1400Z-2(d)(3)(A)(ii) (reference to §1397C(b)(2)); Reg. §1.1400Z2(d)-1(d)(3)(i). There are a total of four safe harbors that businesses may use to meet this test. The first safe harbor rule is the hours-of-services-received test. Reg. §1.1400Z2(d)-1(d)(3)(i)(A). The second safe-harbor rule is the amounts-paid-for-services test.Reg. §1.1400Z2(d)-1(d)(3)(i)(B). The third safe harbor rule is the necessary-tangible-property-and-business-functions test. Reg. §1.1400Z2(d)-1(d)(3)(i)(C). The fourth safe harbor rule is a facts and circumstances test that requires at least 50% of a business's total gross income to be derived from the active conduct of a trade or business within a QOF. Reg. §1.1400Z2(d)-1(d)(3)(i)(D). *See* Maule, 597 T.M., *Tax Incentives for Economically Distressed Areas; Qualified Opportunity Zones* at n. 4056.


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portunity Zone Business Property (QOZBP) unless the property had been used in an OZ census tract before acquisition or was acquired from a Related Party (more than 20% common ownership in the QOF).

Leased assets, even if acquired from a Related Party, are treated as first used by the acquiring taxpayer, however, special Related Party lease rules (which are much less onerous than the Related Party rules applicable to purchased assets) must be followed to ensure QOZBP eligibility.

Another possible method for getting assets into a new business is for the QOF investor to contribute qualifying assets into the QOF, in which case the Related Party rules are not applicable. The downside of a contribution of assets (in lieu of cash) to a QOF is that no eligible gain is triggered for OZ reinvestment and the contributing taxpayer's eligible QOF reinvestment is limited to the ***lesser*** of their: (i) tax basis in the property contributed or the (ii) fair market value in the contributed asset. The secondary problem is that the contributed asset is not treated as QOZBP since it was not ''purchased'' after 2017. Dropping the assets down into a QOZB also causes technical issues which will complicate meeting the aforementioned 70/30 QOZB qualification test.

Based on the statute and regulations it is important that the QOZB ***purchase*** the assets and primarily run the business operation, rather than the QOF. This is to allow the operating business to obtain the 31-month or the newly introduced 62-month ''start-up'' business working capital safe harbor relief,[8] and also secure the more liberal 70% QOZBP requirement vs. the stringent 90% requirement for QOF's.[9] This means the QOF can hold up to 30% non-QOZBP – or ''bad assets'' without subjecting the QOF to penalties (currently five percent annualized) for failing the semi-annual qualification testing.

## Acquiring or Relocating an Existing Non-OZ Business Into an OZ Census Tract(s)

Moving an existing business that has not previously operated in an OZ census tract into an OZ census tract can offer a number of complexities; however, with advanced planning and cash infusions, acquiring an existing business and qualifying it as a QOZB is possible.

If the business is currently owned by more than 20% of the ultimate QOF equity owners, then the assets brought into the QOF or QOZB will be an ineligible non-QOZBP. This does not eliminate the possibility of qualifying the business as a QOZB provided the investors plan on investing material amounts into the transferred business.

For example, if the QOZB acquires business assets not previously used in an OZ census tract from a related party for $500,000, such assets are non-QOZBP, but provided this amount remains less than 30% of total QOZB assets, the QOZB can still meet the qualification tests. Therefore, provided the QOZB has at least $1,666,667 of total assets ($500,000/30%), then the QOZB should meet the qualification test.

If tangible assets are acquired from a third-party, and if the QOZB doubles the basis in the depreciable assets acquired within 30 months then QOZB will be treated as the ''original user'' and all the acquired assets will be QOZBP and the total investment can be minimized as compared to the Related Party acquisition. Note that raw land and intangibles are not required to be ''substantially improved.''

## Qualifying an Existing OZ Operating Business for OZ Benefits

In a case where an existing business has already been operating within an OZ census tract prior to 2018, all of the operating assets of the business are treated as ineligible and non-QOZBP since the assets had been used in the OZ before acquisition. As a result, an existing entity with $500,000 of net tangible assets will only qualify as a QOZB if the new investors make significant investments sufficient to drive down the non-qualified assets below 30%. Similar to the calculation in the above paragraph, the QOF/QOZB must be willing to invest at least 234% of additional funds ([$1,666,667 - $500,000]/$500,000) into the business in order to dilute the $500,000 of non-QOZBP/''bad assets'' below 30%.

Similar investments will be required whether the existing business attempts to qualify itself as an OZ business for a third-party acquisition by making the additional expansion investment or whether the business sells its assets to a QOF or equity to a QOZB before the additional cash infusion, the new owner must invest at least 2.34 times/234% more into the business to meet the 70% for at least the 31 or 62-month working capital safe harbor period.

Note that the QOF does not need to acquire 100% of the existing business in either of the two above paragraphs.

# COMBINING SECTION 1202 (QUALIFIED SMALL BUSINESS STOCK) AND THE FEDERAL OPPORTUNITY ZONE PROGRAM

While the new OZ program is arguably the most powerful and flexible tax diversification tools in the

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[8] Reg. §1.1400Z2(d)-1(d)(3)(v)(F).

[9] Reg. §1.1400Z2(d)-1(d)(3)(viii).


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last four decades, §1202 – Qualified Small Business Stock (QSBS) may very well be a close second.

The QSBS eligible gain exclusion amount is the greater of: (1) 10 times the taxpayer's adjusted basis in the QSBS disposed of in that year ''annual limitation;'' or (2) $10 million reduced by the aggregate amount of QSBS gain on stock of that issuer excluded by the taxpayer in prior years ''aggregate limitation.''

While these annual and cumulative limits (per investor) are more restrictive than the unlimited OZ Program exclusion after a 10-year hold, most investors will be content with a 1,000% ROI or a $10,000,000 gain (per qualifying investor) exclusion.

For the sale of QSBS by non-C Corporation taxpayers, a partial or full exclusion of gain is allowed under §1202. Section 1202 defines QSBS as stock:

i. Issued by a domestic C corporation with gross assets equal to or less than $50 million;

ii. Issued after August 10, 1993, for money, other property (not including stock), or as compensation for services;

iii. Issued by a corporation that uses at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses during substantially all of the taxpayer's holding period for such stock, and such corporation must be an eligible corporation;

iv. Held by a person that is not a C corporation;

v. Held for more than five years;

vi. With some exceptions, acquired at original issue; and

vii. Qualified Small Business issuer may not redeem its stock within specified time periods.

The portion of the taxpayer's eligible gain exclusion varies based on when the taxpayer acquired the stock. For QSBS acquired between:

- August 11, 1993, and February 17, 2009, the gain exclusion is 50%;[10]
- February 18, 2009, and September 27, 2010, the gain exclusion is 75%;[11] and
- September 28, 2010, and thereafter, the gain exclusion is 100%[12]

Therefore, properly structuring a QSBS entity within a QOZB can yield more flexibility and possibly more favorable tax results upon an exit prior to 10 years.

To the extent a QOF establishes or acquires a QSBS-eligible entity pursuant to §1202 (being cognizant of certain non-qualifying trades or business such as most service and real estate operations) the entity can be eligible for a 100% federal (and most state) gain exclusion after the fund holds the entity for at least five years – rather than the 10-year OZ holding period. Private equity and venture funds tend to like this strategy since a five-year holding period is more in line with their general disposition timeframe.

A strategy to consider is establishing the QOZB as an LLC/Partnership to allow start-up losses to flow-through to the members/ partners and then convert to the required C corporation status once the entity turns profitable; thereby starting the five-year QSBS holding period clock ticking.

Therefore, combining the new OZ provisions with QSBS classification can give investors two bites at the federal exemption apple and dramatically enhance the investment flexibility.

## SECTION 1045

Section 1045 is another taxpayer friendly section that coincides with §1202. §1045 allows non-C corporation taxpayers to elect to defer recognition of gain from the sale of QSBS if the taxpayer purchases replacement QSBS within a 60-day period beginning on the date of the QSBS sale. The election must be made on a timely filed tax return (including extensions). The amount of gain deferred is calculated in a manner similar to gain deferred in a like-kind exchange. Unlike §1202, the minimum holding period of the relinquished QSBS under §1045 is only six months and there is no limit to the amount of the gain deferral.

This further allows interim dispositions within the OZ fund without triggering gain.

## COMBINING OTHER TAX BENEFITS WITH THE OZ PROGRAM

The added advantage of using the OZ program for operating businesses is that additional federal and state tax incentives, including various hiring and asset tax credits, grants, exemptions and other benefits are available to the QOZB, QOF and/or equity holders. This can further compound the after-tax ROI on OZ investments.

[10] §1202(a)(2).
[11] §1202(a)(3).
[12] §1202(a)(4).


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