Operating Businesses and Opportunity Zones

D&S Opportunity Zone Practice Group
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The real estate community got plenty of good news last month when Treasury released the second set of proposed regulations (the "Round 2 Proposed Regulations") on the Opportunity Zone program (the "OZ Program"). (See our update here on the Round 2 Proposed Regulations.) Equally as critical for those living in the Land of OZ, the Round 2 Proposed Regulations also contained much anticipated guidance on how non-real estate operating businesses can fit within the OZ Program. The expansion of the OZ Program to operating businesses is certainly welcome news for investors interested in forming and operating businesses in an Opportunity Zone. More importantly, operating business will be the driving force behind the economic development that is at the heart of the OZ Program's policy goals.

For our good friends in the real estate industry, this is relevant to you too! Once you have built a new retail, office or mixed-use facility, you are going to need tenants. The OZ Program is now a huge marketing tool you have to attract tenants to your space, since operating businesses (and their investors) can now jump on the OZ Program bus. And of course if you want to start a real estate related business in an Opportunity Zone, you will need to follow these rules as well.

This Road Map assumes some familiarity with the OZ Program. If you are new around here, take a look at some of our earlier Road Maps on Opportunity Zones.

Here is our roadmap for operating businesses. Right this way to the Land of OZ!

1. **Don't Get Turned Around: The Tax Benefits Have Not Changed**

It is true that the Round 2 Proposed Regulations contained a lot of new guidance applicable to operating businesses, but the overall framework of the OZ Program has not changed. Investors with eligible gain can invest into a QOF within the required 180-day investment period,[1] and those investors are eligible for the full bundle of tax benefits.

As a quick reminder, here is a high level timeline of the OZ Program from the investor perspective and the associated tax benefits:

- Step 1: An investor sells an existing appreciated asset.
- Step 2: The investor invests the gain portion of the sale proceeds into a Qualified Opportunity Fund ("QOF") within 180 days.

[1] The first day of an investor's 180-day period to reinvest eligible gains into a QOF can vary depending on the type of gain and whether the investor sold the appreciated asset directly or through a partnership. See our earlier Road Maps for a discussion of these issues.

  - **TAX BENEFIT #1 –** The investor defers the entire amount of the eligible gain that is reinvested into the QOF.
- Step 3: The investor pays tax on the deferred gain at the earlier of (i) the sale of its interest in the QOF, or (ii) December 31, 2026 (in either case, the "Inclusion Date").
  - **TAX BENEFIT #2 –** If the investor has held its QOF interest for at least 5 years prior to the Inclusion Date, 10% of the deferred gain is permanently forgiven. If the investor holds its QOF interest for at least 7 years prior to the Inclusion Date, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven. (Note that to get the 7-year benefit, an investor must invest in a QOF no later than December 31, 2019.)
- Step 4: The investor sells its interest in the QOF at exit.[2]
  - **TAX BENEFIT #3 –** If the investor holds its QOF interest for at least 10 years, there is no tax at all on the gain realized by the investor at exit.

Investors who invest in a QOF are eligible for these QOF tax benefits regardless of whether the QOF invests in an underlying real estate deal or an underlying operating business in an Opportunity Zone.

2. Still Two Tiers: The QOF Structure Has Not Changed

We have been advocating use of the "two-tier" structure for real estate investments, and that same structure applies for operating business investments. In fact, although a "single-tier" QOF structure can in theory be made to work in certain circumstances for a real estate investment, an underlying investment in an operating business really must be done through the two-tier structure. So, both real estate QOF structures and operating business QOF structures will have some structural commonalities.

Under the two-tier structure, investors invest into a QOF, and the QOF acquires an interest in a lower-tier partnership or corporation (the "Subsidiary Company"). The QOF still has its 90% asset test to meet twice a year, and the value of the QOF's ownership interest in the Subsidiary Company will count as a good asset for purposes of the QOF's 90% asset test as long as the Subsidiary Company meets its own set of requirements.

3. Same, Same but Different: The Qualified Opportunity Zone Business

In order for the equity of the Subsidiary Company to be a good asset in the hands of a QOF, the Subsidiary Company has to be a Qualified Opportunity Zone Business ("QOZB"). There are five requirements that a Subsidiary Company must satisfy in order to be a QOZB:

[2] See Part 9 below for a discussion about possible exit strategies.

i) The Tangible Property Requirement;
ii) The Gross Income Requirement;
iii) The Intangible Property Requirement;
iv) The 5% Financial Property Limit; and
v) The Sin Business Prohibition.

Although these same five requirements apply in the context of a real estate investment (a "Real Estate QOZB"), the emphasis and focus of the QOZB rules in an operating business context will be different and the Gross Income Requirement will be much more important.

4. Whether You Own Something or You Own Nothing: The Tangible Property Requirement

Even though QOZBs that operate a business in an Opportunity Zone ("Operating Business QOZBs") may not own or acquire much real property, if any, they still need to comply with the Tangible Property Requirement (which picks up real property, personal property and leased property). Under the Tangible Property Requirement, substantially all (which is 70% for this purpose) of the tangible property owned or leased by the QOZB must be Qualified Opportunity Zone Business Property ("QOZBP").

In order for property to qualify as QOZBP, there are three requirements:

- First, the QOZB must meet either the Original Use test or the Substantial Improvement test with respect to the tangible property;
- Second, the tangible property must have been acquired by purchase after December 31, 2017 (the "Purchase Requirement"); and
- Third, the QOZB must meet the Substantially All Tests (defined below).

The rules apply differently to owned property and leased property, so we will run through the application of the rules in each context. Even if you understand the QOZBP rules for real estate, it's worth coming along for the ride to understand the variations for an Operating Business QOZB.

a. Property Owned by a QOZB

As noted above, even if an Operating Business QOZB does not own real property, an Operating Business QOZB will typically have some amount of owned personal property.

i. Original Use All the Way

Both Real Estate QOZBs and Operating Business QOZBs must ensure that substantially all of their tangible property meets either the Original Use test or the Substantial Improvement test. As you will see, Operating Business QOZBs will almost certainly be relying on the Original Use test.

In order to meet the Substantial Improvement test, a QOZB has to double its basis in the property in a 30-month period. Applying the Substantial Improvement test in a real estate context is fairly straightforward: a QOZB acquires real property such as a building and substantially improves it within the required timeframe. However, in the context of an Operating Business QOZB, it may be difficult (or impossible) to double the basis of certain business assets. For example, you cannot double the basis of a desk chair by buying a second desk chair, and most people wouldn't bother improving their existing desk chair by a substantial amount (diamond studded arm rests perhaps?).

Instead, most Operating Business QOZBs will buy new equipment (desk chairs, computers, machinery, etc.) for use in the business. The Round 2 Proposed Regulations included a very user-friendly definition of Original Use, stating that any property newly placed in service (for depreciation purposes) by the QOZB meets the Original Use test. So any new equipment placed in service by the QOZB will count as good tangible property for purposes of the 70% Tangible Property Requirement.[3] For example, any new equipment or other personal property purchased and put to use for the first time in an Opportunity Zone by the QOZB will be QOZBP (subject to the Purchase Requirement and the Substantially All tests discussed immediately below).

ii. Arm's Length Only for Purchases

The Purchase Requirement for tangible property acquired by an Operating Business QOZB is the same Purchase Requirement that applies to real property acquired by a Real Estate QOZB. Substantially all of the tangible property in an Operating Business QOZB must be acquired by purchase from an unrelated party after December 31, 2017. Contributions of business assets will not qualify, and acquisitions from a related party (defined with a 20% threshold for relatedness) will similarly not qualify.

This is unlikely to be a significant hurdle. For example, just buy the office equipment from a real third party.

iii. Substantially All and Substantially All

The third requirement of the QOZBP definition requires that during substantially all (90% for this purpose) of the QOZB's holding period of QOZBP, substantially all (70% for this purpose) of the use

[3] The Round 2 Proposed Regulations also say that used tangible property can satisfy the Original Use test if the property has not been previously used or placed in service in the Opportunity Zone. So presumably an Operating Business QOZB could buy used tangible property as long as it was not used in the Opportunity Zone where the Operating Business QOZB will use it.

of the property be in an Opportunity Zone (the "Substantially All Tests"). The application of the Substantially All Tests is the most untested aspect of the QOZBP definition so far.

Unlike real estate, which tends to stay in one place, QOZBP used by an Operating Business QOZB may very well travel. For example, an employee may use a laptop in the office as well as on the road or at home. Will this be a purely hours-based approach or will Treasury get comfortable with some other metric such as sales generated with use of the laptop in or out of an Opportunity Zone? Until we get more clarity here, keep good records on the use of your tangible property. Hopefully Treasury will generate some safe harbors here to dovetail with the safe harbors for the Gross Income Requirement (discussed below).

b. Property Leased by a QOZB

The leased property rules are the most advantageous guidance in the Round 2 Proposed Regulations for Operating Business QOZBs. In addition to clarifying that leased property can also qualify as QOZBP (which was murky based on the language in the Internal Revenue Code (the "Code")), leased property gets to sidestep a few of the QOZBP requirements.

i. As Is, Where Is: No Improvements Required

Neither the Original Use test nor the Substantial Improvement test apply to leased property. So an Operating Business QOZB can lease its office space without any requirement to build anything new or improve the property. This is a sensible rule for Operating Business QOZBs, since an operating business should be focused on making widgets, not spending investor dollars on upgrading the office space.

Notably, Real Estate QOZBs can use this rule too and any improvements made to the leased property can satisfy the Original Use requirement. For example a Real Estate QOZB can be the tenant on a ground lease and build new property that should qualify as QOZBP.

ii. We're All Family Here: No Related Party Restriction

Although the lease does have to meet a variation of the Purchase Requirement, the critical related party test drops away. The lease must be entered into after 2017, and it must have arm's length and standard market terms, but there is no requirement that the lessor and lessee be unrelated parties, as would be the case for property acquired by a Real Estate QOZB by purchase. If five investors formed a QOF to invest into a Real Estate QOZB to build a new building in an Opportunity Zone, those same five investors could form a second QOF to invest in an Operating Business QOZB to rent out space in the new building. This could be a huge kick to development in an area, since real estate investors who develop property in an Opportunity Zone are already incentivized to encourage additional economic activity and growth in that Opportunity Zone.

If the lessor and lessee are related, a few additional requirements kick in including a prohibition on prepayments. There is also an anti-abuse rule which disqualifies leased property as QOZBP if there is a plan, intent or expectation that the underlying real property could be purchased for anything other than its fair market value at the time of purchase.

iii. Still Substantially All

The third QOZBP requirement (the Substantially All Tests) applies as drafted, so substantially all of the use of the leased property must be in an Opportunity Zone for substantially all of the period for which the property is being leased by the Operating Business QOZB. For real property leases, this requirement is satisfied virtually automatically. Keeping track of property used via an equipment lease may be more complicated, so again keep good records.

Overall the leased property rules are very user-friendly, so this is a big win for developers looking to market their spaces for lease and for investors looking to start a business in an Opportunity Zone.

5. Follow the Money: The Gross Income Requirement

The most eagerly awaited guidance for Operating Business QOZBs was clarification on the Gross Income Requirement. Some (brief) history will help to explain the anticipation here. The Gross Income Requirement as drafted in the Code (after working through a few cross-references) was fairly benign: a QOZB has to generate at least 50% of its gross income from the active conduct of its trade or business. An initial read of the Gross Income Requirement implied no explicit geographical limitation on the generation of the income, but the application of the cross-references was less than crystal clear.

The first round of regulations released in October 2018 (the "Round 1 Proposed Regulations") modified this requirement and said that 50% of the gross income of a QOZB has to be derived from the active conduct of a trade or business in the Opportunity Zone, which triggered a flurry of questions. How exactly do you measure the generation of income when sales and ultimate consumers may occur outside of an Opportunity Zone?

The Round 2 Proposed Regulations answer that question with three safe harbors and a catch-all facts and circumstances test. An Operating Business QOZB only has to satisfy one of the safe harbors, or the facts and circumstances test, in order to meet the Gross Income Requirement.

a. Hours-Based Safe Harbor

The Hours Safe Harbor will be met if at least 50% of the services performed (based on hours) for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed within an Opportunity Zone.

For example, a start-up software business located in an Opportunity Zone develops software for sale to customers globally. Even if the majority of the sales are to customers outside of an Opportunity Zone, the business can satisfy the Hours Safe Harbor as long as the employees and independent contractors of the business do their work within the Opportunity Zone.

b. Compensation Safe Harbor

The Compensation Safe Harbor will be met if at least 50% of the services performed for the QOZB by its employees and independent contractors (and employees of independent contractors) are performed in an Opportunity Zone, based on amounts paid for the services performed.

If the software business mentioned above has an office in an Opportunity Zone and a service center not in an Opportunity Zone, even if more hours are logged by the employees at the service center, the business can meet the Compensation Safe Harbor if the business pays at least 50% of its total compensation to employees working at the office in the Opportunity Zone. Again, you only need to win under one of the safe harbors to meet the Gross Income Requirement.

c. Property and Management Safe Harbor

The Property and Management Safe Harbor will be met if (1) the tangible property of the QOZB that is in an Opportunity Zone, and (2) the management or operational functions performed for the QOZB in an Opportunity Zone are each necessary to generate 50% of the gross income of the trade or business.

For example, if a landscaper's headquarters are located in an Opportunity Zone, its officers and employees manage the daily operations of the business from that headquarters, and all of its equipment and supplies are stored at the headquarters or elsewhere in the Opportunity Zone, then this safe harbor will be met even if the landscaping work is done outside of an Opportunity Zone.

d. Facts and Circumstances

If none of these safe harbors are available, the QOZB can still satisfy the Gross Income Requirement if it can establish, based on all the facts and circumstances, that at least 50% of its gross income was derived from activities in an Opportunity Zone. Having a PO Box or other delivery address in an Opportunity Zone is not sufficient.

6. Keep it Local: The Intangible Property Requirement

To the extent a QOZB has intangible property, a substantial portion of the QOZB's intangible property must be used in the active conduct of its trade or business in an Opportunity Zone. The Round 2 Proposed Regulations defined "substantial" for this purpose as 40%, so there is a fair amount of leeway here.

For example, if a widget factory is using a patent, the 40% substantiality test should be met easily. If your intangible property can travel (such as a program installed on a laptop), this is another area where you should keep robust use records for your files.

7. Investing in the Community: The 5% Financial Property Limit

The OZ Program was not intended to permit investors to invest in financial products and get the OZ Program tax benefits. Congress drafted the OZ Program provisions in the Code to encourage investment in the Opportunity Zones to drive economic activity. To monitor this concern, less than 5% of a QOZB's assets can be nonqualified financial property (the "5% Financial Property Limit"). Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property.

However, reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less do not constitute nonqualified financial property, so a QOZB can keep reasonable cash reserves, for example.

a. The 31-Month Safe Harbor

The Round 1 Proposed Regulations contained a safe harbor permitting Real Estate QOZBs to treat cash as reasonable working capital for a period of 31 months if certain requirements are met, including having a written plan and schedule to spend the funds within 31 months, as well as actually spending the cash consistently with the plan. The Round 2 Proposed Regulations extend this safe harbor to Operating Business QOZBs. This was a logical extension of the rule, since new and expanding operating businesses often have significant startup expenses.

b. Another Category of Sin Business

The 5% Financial Property Limit effectively adds banking as a new sin business that QOZBs are prohibited from engaging in, since debt is not permitted property past 5% of a QOZB's assets. It remains to be seen if Treasury will carve out an exception for local banks serving the needs of new QOZBs.

Similarly, QOZBs that want to engage in investment management services need to tread carefully. Fee-based advisory services are okay, but any profits interests granted by other funds or investment vehicles will be subject to the 5% Financial Property Limit since those profits interests are partnership interests. Even though a profits interest is typically assigned zero value on grant, the 5% Financial Property Limit looks at the QOZB's basis in its assets. The basis of a partnership interest can fluctuate with allocations of partnership debt, as well as mismatches between income allocations and cash distributions, so holding profits interests will be tricky to navigate here.

8. On the Straight and Narrow: The Sin Business Prohibition

Aside from banking (and holding other financial assets) as mentioned above, the QOZB cannot be a specified sin business, which includes massage parlors, hot tub facilities, suntan facilities, racetracks or other gambling facilities, golf courses, country clubs, and liquor stores.

Don't fall off the wagon!

9. Don't Miss Your Exit: The 10-Year Benefit

The 10-year tax benefit as drafted in the Code requires an investor to sell its QOF equity interest. The Round 2 Proposed Regulations offered some potential relief here and include provisions that would permit a QOF investor to claim the benefit of the 10-year rule and exclude from income any capital gain resulting from certain property sales by a QOF partnership (the "10 Year Asset Sale Election"). There are a few things to keep in mind about this new 10 Year Asset Sale Election. First, the Round 2 Proposed Regulations only expressly permit the 10 Year Asset Sale Election for sales of property by a QOF. So presumably QOF investors can make the 10 Year Asset Sale Election if a QOF sells the QOZB, but as of now QOF investors cannot make the 10 Year Asset Sale Election if a QOZB sells its assets. The 10 Year Asset Sale Election may be more helpful for Operating Business QOZBs that can actually sell their business by selling the QOZB, as opposed to a Real Estate QOZB where a buyer would typically prefer to buy the underlying property.

Second, the 10 Year Asset Sale Election only permits QOF investors to exclude from income capital gain from a sale of qualifying property, so any ordinary income that results from a qualifying sale is not excluded and would be taxable. Ordinary income would arise from the sale of dealer property such as inventory, and any depreciation recapture characterized as ordinary income would also have to be included in income.

Third, unlike the Round 1 Proposed Regulations and each other section of the Round 2 Proposed Regulations, taxpayers cannot rely on the 10 Year Asset Sale Election until the regulations are finalized. So there is no protection for a structure that is put in place now which assumes that QOF investors will be able to claim the benefit of the 10 Year Asset Sale Election for sales of the QOZB or sales of the underlying property.

In the meantime, although we expect that it would be incredibly difficult for Treasury to walk this rule back, we advise structuring a QOF in a manner that facilitates an entity sale at exit in case the 10 Year Asset Sale Election is not finalized (or not finalized in a helpful way).

10. You Have the Map – Ready to Go?

The rules in the Round 2 Proposed Regulations for Operating Business QOZBs look very good on paper. As investors try to put their dollars to work and form businesses in the Opportunity Zones, we will see where the potholes form.

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The D&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

- Jessica Millett (Tax Practice Co-Chair) 212-692-5988 / jmillett@dsllp.com
- Stephen Land (Tax Practice Co-Chair) 212-692-5991 / sland@dsllp.com
- Brad Borden (Tax Special Counsel) 212-692-5520 / bborden@dsllp.com
- Terri Adler (Managing Partner and Real Estate Practice Chair) 212-692-5533/tadler@dsllp.com
- Bruce Stachenfeld (Chairman and Real Estate Philosopher®) 212-692-5550 /bstachenfeld@dsllp.com