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Qualified Opportunity Zone Alert

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Opportunity Zones & Startup Tech Companies IRS Guidance: Round Two Outline

On April 17, 2019, the IRS released a second round of guidance (Round Two Guidance) with respect to Qualified Opportunity Zones (QOZs), which supplements the 2018 proposed regulations. Topics that deserved clarification and were addressed favorably in Round Two Guidance regarding startup businesses were (1) the use of capital gain dollars toward operations (other than tangible property development) and (2) startup tech businesses where the focus is the development of intangibles, such as software and biomedical technology.

This topic attracted much attention and our firm submitted a November 2, 2018 comment letter to the IRS and Treasury. The open points were addressed. Our letter can be found on the Thompson Hine Opportunity Zone website under Publications for November 2, 2018 and January 29, 2019. Investing in operating businesses differs from real estate development because (1) the favorable 31-month safe harbor pursuant to the 2018 proposed regulations to allow holding large cash amounts was limited to tangible property development, (2) questions existed as to when an operating business' income is from sales and product uses outside the QOZ, (3) the relatively limited amount of tangible property used in some startup operations, and (4) the impact of leasing arrangements.

The following outlines investments in startup tech companies that were favorably addressed in Round Two Guidance. It will not repeat points addressed in a separate summary regarding the more general points of Round Two Guidance. A more detailed version is available on our website.

A. 31-Month Safe Harbor Available for Cash Used Toward Operations.

1. Cash invested in operating entity can be held for 31 months and applied towards development of a business without violating "nonqualified financial property" requirement.
   a. Requirements include identifying how cash will be spent.
   b. Exception provided for delays stemming from government approvals, if any, needed with respect to use of cash.
   c. 31-month rule can be used multiple times for different tranches of equity infusion during overlapping periods.
   d. Identifying use of cash towards salaries, licenses and other expenses is now permitted.
2. Favorable consequences during 31-month period from this expanded rule are:
   a. Intangible business assets treated as used in the active conduct of a business.
   b. Tangible property to be acquired, constructed, improved or leased pursuant to new favorable rules treated as "qualified business property" for purposes of the 70% requirement.
   c. All earnings on cash held are treated as qualifying revenue from an active conduct of a business.

B. Active Conduct of a Business—After Initial Safe Harbor Period Ends.

After 31-month safe harbor period (or earlier point when identified cash is spent), startup business must be considered engaged in the "active conduct of a business."

Definition was reserved for later clarification.

C. Requirement that 50% of the QOZ Business Gross Income Is Derived from the Active Conduct of a Business *in the QOZ* Can Be Satisfied Even though Products and Services are Sold to Customers Outside the OZ.

Four alternative methods to qualify annually with respect to operations of employees, independent contractors and employees of independent contractors.

1. **Hours Worked in QOZ Test.** Are 50% or more of the aggregate services provided on behalf of the business performed in the QOZ, taking into account the **number of hours performed?**
2. **Compensation Paid for Services in QOZ Test.** Are 50% or more of the aggregate services provided on behalf of the business performed in the QOZ, taking into account **the total amount paid by the entity?**
3. **Management in QOZ Test.** Tangible property of the business is located within the QOZ **and** the management or operational functions performed within the QOZ are each necessary for the generation of at least 50% of the gross income of the business.
4. **Facts and Circumstances Test.** If operating entity's sole operation location is in a QOZ and its only activity located outside the QOZ is some sales function, there should be a method to fit within one of the above alternative tests. Analysis can be more challenging as the business has operations both within and outside of a QOZ, particularly as operations grow.

D. Sales or Licensing of the Business Intangibles Outside the QOZ Should Be Fine, Where All Operations to Develop the Software and Operations Occurs in the QOZ.

Round Two Guidance defines "substantial portion" of the intangibles that must be used in the active conduct of a business in a QOZ as requiring at least 40% of the intangibles be used in QOZ.

1. Business needs to monitor level of activity out of employee's home.
2. Scrutiny increases if operations occur outside of QOZ.

E. *Substantially All* (70%) of the Tangible Property *Is Used* in a QOZ.

For tangible property to qualify as QOZ Business Property, a requirement is that substantially all of its use is in a QOZ. For this purpose, substantially all is defined as at least 70%.

1. Startup tech companies that have all operations within a QOZ typically use very little tangible property outside the main headquarters.
   a. Product and software sold to customers should be excluded after the sale.
   b. If manufactured equipment and related software is leased to customers, consider approach that eliminates continuing payment for the equipment.

F. Substantially All (70%) of Tangible Property Owned or Leased by the Operating Business Must Be Qualifying Business Property.

For tangible property to be qualifying business property for purposes of the 70% test, such property must be considered (1) original use property in the QOZ, (2) substantially improved property in the QOZ, or (3) leased property that fits within new favorable rules.

1. To the extent that the startup tech company has relatively small amount of tangible property, additional amount needed to satisfy the 70% test would not be large.

2. Favorable rules provided regarding executing leasing tangible property arrangements and inclusion of such property in the numerator of the 70% test, without purchasing additional property.
3. Where startup business is leasing property currently, remaining lease term needs to be valued pursuant to the new guidance and then new leases need to be entered for additional tangible property during the 31-month period to meet the 70% requirement.

G. Existing Entity—Timing for Satisfying the QOZ Business Requirements.

Round Two Guidance could have been clearer that existing startup companies can be treated as new entities not needing to be a QOZ business at time that capital gains are invested in such entity, if they otherwise satisfy the QOZ requirements in the future, such as the 31-month safe harbor, but this should be the result.

H. Tax Status of an Existing Entity.

Existing startup businesses that are C corporations should consider:

1. What properties to take into account for purposes of "nonqualified financial property" limitation that permissible cash held by operating entity be less than 5% of the unadjusted tax basis in the property of QOZ business.
2. Feasibility to convert C corporation to LLC to allow future net operating cash to be distributed in a tax efficient manner.

I. Structuring.

If the above points can be addressed favorably, common structure would be for the capital gains dollars to be invested in a newly formed LLC that acts as a QOF in exchange for a 99% interest and the QOF invests the cash into the existing startup entity in exchange for an equity interest. Additional financing, as needed, would be incurred at the operating entity level.

J. Exit Strategy.

1. Preferred approach for capital gain investors to benefit from tax free appreciation benefit is to sell interest in QOF after 10-year holding period, rather than a sale of QOF interest in the operating entity or sale of operating entity's assets.
2. In context of startup companies, consideration needs to be given to impetus to sell when inherent value is apparent, which may in fact be less than 10 years.

All requirements to having a QOZ business must continue to be satisfied throughout the period (at least 90%) that the investors want to benefit from the tax free appreciation. If all requirements are not met, then the tax free appreciation benefit might no longer be available. Consideration needs to be given to this point in connection with the growth of the business.

FOR MORE INFORMATION

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