OPPORTUNITY ZONES AND STARTUP TECH COMPANIES IRS GUIDANCE: ROUND TWO SUMMARY

By Thompson Hine LLP

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 discusses how points regarding investments in startup tech companies 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 short version is available on our website.

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

The 2018 proposed regulations permit cash to be held for 31 months as reasonable working capital without violating the requirement that cash represent less than 5% of the aggregate unadjusted tax basis of the property of a QOZ business. Under the 2018 proposed regulations, this safe harbor for cash was limited to acquiring, constructing, and/or rehabilitating real or personal tangible business property if there is (1) a written plan that identifies the cash as held for property development, (2) a written schedule consistent with ordinary business operations showing how the cash will be spent over the construction period (not to exceed 31 months) and (3) the business substantially complies with the schedule.

Round Two Guidance extends this 31-month safe harbor to allow cash to be used towards the development of a business in a QOZ, within the same constraints as listed above. This is very favorable in many respects:

a. The cash can be applied towards salaries, licenses, and other cash expenses during such 31-month period, which can be very helpful towards the development of a startup business.

b. The startup business' intangible assets are treated as used in the active conduct of a business during such 31-month period.

c. The startup business' tangible property to be acquired, constructed , improved or leased pursuant to new favorable rules is treated as qualified business property during the 31-month period for purposes of the 70% requirement, which mandates that the post-investment tangible property qualify as original use, substantially improved, or leased in compliance with certain requirements.

d. All earnings on the cash held by the operating company in compliance with the necessary written detailed plan with respect to the use of such funds are treated as qualifying revenue from an active conduct of a business during such 31-month period. If the earnings on the cash is the only income during such period, then the 50% income test (described in C below) would be met.

Additional potentially helpful points from Round Two Guidance regarding the 31-month safe harbor are:

(1) The 31-month period is extended if the cash cannot be spent consistent with the scheduled detail during such period due to a delay stemming from waiting for governmental action on a completed application.

(2) The 31-month safe harbor to hold cash can be used multiple times with each capital gain investment in an operating entity, and the safe harbor periods may overlap.

<u>B. Active Conduct of a Business—After Initial Safe Harbor Period Ends.</u>

As stated above, the startup venture is considered engaged in the active conduct of a business during the 31-month safe harbor to apply cash held by the operating entity towards development of a business.

On or before the end of the 31-month safe harbor period, consideration needs to be given to situations where a startup business remains in startup mode and might not yet be generating revenue. First, consideration should be given to whether the activity qualifies as a "business" for tax purposes at that point. Second Round Guidance refers to the definition of a business within Section 162 of the Internal Revenue Code as the applicable standard. Second, the Second Round Guidance leaves unanswered the definition of what is active conduct of a business. Our comment letter requested some simple standard, such as having a reasonable expectation that within some designated period the entity will generate revenue, but the definition of active conduct of a business was left reserved for future action.

<u>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.</u>

Second Round Guidance addresses the requirement of when income is considered derived <u>within the QOZ</u>, particularly when goods or licenses are provided to customers located outside the

QOZ. Income is considered coming from the active business in the QOZ by satisfying one of four alternative methods:

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 by employees and independent contractors (including employees of independent contractors) during each tax year?

A startup software company that sells its product through internet download satisfies this test, even if all of the consumer base is located outside the QOZ, provided that the majority of the aggregate workers' hours are performed on the QOZ campus.

Questions that arise are:

a. How are hours calculated for independent contractors, where these arrangements might not be based on hours and where a contractor might not itemize the hours worked on an invoice?

b. How is information regarding employees of independent contractors to be accessed?

c. For executives who split their time working within the QOZ and also to market the product outside of the QOZ, records maintained for local income tax reporting, if any, could be useful. Hopefully, future guidance will provide that a business with operations only within a QOZ will not need to account for employees who travel to market the product or service or otherwise.

d. The business might have to monitor the amount of hours that software developers work from their home, if located outside the QOZ.

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 to employees and independent contractors (including employees of independent contractors) during each tax year?

A startup business within a QOZ that has a service center outside the QOZ with the majority of the aggregate workers' hours spent outside the QOZ satisfies this test if the operating entity pays 50% of its total compensation for software development and other services provided on the QOZ campus. This method could be considered for a business that locates its highly paid employees in a QOZ and has lower paying employees or independent contractors working outside the OZ.

Questions similar to those stated in (1) above arise in this context too. Also, are all forms of compensation taken into account and when are amounts considered paid for this purpose? For example, are bonuses taken into account in the year paid or for the year that the related services are rendered? How is this test applied with respect to bonus compensation paid for a multi-year performance period? How would deferred compensation count towards this calculation?

3. Management Test. The 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. If a startup business might not fit within either of the first two tests, and the management occurs within the QOZ even though sales and marketing occurs outside the QOZ, this test might provide the favorable result.

4. Facts and Circumstances Test. A very broad facts and circumstances that at least 50% of the QOZ business income is from the active conduct of a business in a QOZ.

Each fact pattern needs to be evaluated. However, if the 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.

The analysis can be more challenging as the business has operations both within and outside of a QOZ. Also, as a business grows and there is a need to have operations outside a QOZ, consideration can be given to whether such additional operations can be segregated and run from another entity to continue to isolate the operations of the QOZ operating entity, but this would require an allocation regarding the respective values of each business division to capture the tax-free appreciation.

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 this manner. Unlike the explanation regarding the source of revenue. the new guidance does not provide further explanation as to when intangibles are considered used in an active conduct of a business in a QOZ, particularly when intangibles are licensed for use to customers outside the QOZ. Nonetheless, the many aspects of Round Two Guidance would seem to support the conclusion that the use of intangibles by customers outside the QOZ is permissible when all of the operations and management occurs within the QOZ. Further, the emphasis on this requirement should be on whether the intangibles are used in the active conduct of a business provided the business is in a OZ, rather than solely on whether the intangibles are used in an OZ.

The following support the conclusion stated above:

1. The separate rule of whether gross revenue is considered derived in the QOZ is met if all services (operations and management) are provided in the QOZ, even though the intangibles (e.g. software) are all used outside the QOZ. The preamble to the Second Round Guidance provides the example where a software startup business develops software applications on a QOZ campus for global sale. The revenue requirement is met where consumers purchase software applications through internet download and all workers who devote the majority of their time (based on hours) to developing the software applications are on the QOZ campus.

If all of the revenue is considered derived within the QOZ campus, the intangibles should be equally considered used on such campus because of their development on the QOZ campus, even though the software is used by customers located off the QOZ campus. The answer should not change based on where the consumers are located. If the result were otherwise, very common startup businesses would be ineligible for the QOZ provisions.

2. For purposes of determining whether tangible property is used in the QOZ, inventory (as tangible property) is considered used in the QOZ even though such inventory is in transit from the QOZ business to customers located outside the QOZ. Just like the fact that inventory (tangible property) that is in transit should have no impact on whether the QOZ business' tangible property is used outside the QOZ, the status of the intangible en route to the customer and where used by customers should not be taken into account.

3. Again, for purposes of determining whether gross revenue is derived in the QOZ, an example is provided regarding a landscaping business headquartered in the QOZ, with all equipment and supplies stored in the headquarters, and the management activity is also all at the headquarters, with the conclusion that the revenue is considered derived within the QOZ. While not stated, this example would seem to indicate that the fact that the landscaping equipment is used outside the QOZ does not impact the conclusion that the revenue is derived in the QOZ. Again, in the same manner that the use of the landscaping equipment outside the QOZ is ignored to determine the source of the revenue, the landscaping equipment should be ignored for purposes of the requirement that 70% of the tangible property be used in the QOZ. This might be more of a stretch in the context of the required use of tangible property in a QOZ, but should not be an issue in the context of the use of intangibles.

If correct, this point further supports the position that the use of operating business' intangibles outside of the QOZ by customers should be ignored in the analysis of whether the intangibles are used in the active conduct of a business in the QOZ.

The 40% floor would need to be further scrutinized where the operations of a business are within and outside a QOZ, particularly where workers are providing services while working at home or other locations outside of a zone. Some detail and protocols need to be established by the business to assure that the software development work is performed in the 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%.

In the context of a startup tech companies that has all operations within a QOZ, there is typically very little tangible property that is used outside the main headquarters. However, there are instances when a business manufactures and leases equipment in which the technology is contained and made available to customers. In most cases the equipment is sold and the cost paid by the customer covers the tangible property plus the use of the software. Accordingly, the tangible property leaves the QOZ and is no longer taken into account.

In arrangements where the tangible shell property that houses the software is leased and a periodic fee is paid by the customer, some might ask whether the property used pursuant to the lease outside of the QOZ is to be counted in the 70% calculation. For multiple reasons. the leased property that is owned by the operating business but in the possession and use of customers should not factor negatively in the 70% calculation. To be safe, consideration could also be given to selling the equipment to customers and have the periodic fee paid solely for the use of the software.

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.

Each arrangement must be evaluated separately and depends on the amount of tangible property owned or leased by the operating business in advance of the capital gain investment versus the additional tangible property taken into account in the calculation with the capital gain investment and any new financing. To the extent that the startup tech company has a relatively small amount of tangible property, then the additional amount needed to satisfy the 70% test would not be large.

Round Two Guidance provides favorable rules that allows having the operating entity lease tangible property and the inclusion of such property in the numerator of the 70% test, without the need to purchase additional property for tax purposes. Startup businesses typically lease property and the addition of new leased property can work well toward satisfying the requirement that 70% of the tangible property be qualifying property. To the extent that the startup business is leasing tangible property currently, the 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.

Apart from dollars needed to satisfy the 70% tangible property requirement, the additional cash amount can be used towards operational costs such as salaries and other expenses, provided that the 31-month rule discussed above is met.

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

The statute and the 2018 proposed regulations state that an existing entity must be a QOZ business at the time that the capital gain dollars are invested in the operating entity. In contrast, a new operating entity only needs to be organized for the purpose of being a QOZ business and can satisfy the requirements for QOZ business status in the future, for example, pursuant to the 31-month safe harbor.

Round Two Guidance can be clearer on the point, but it seems that a startup business that is not in operation could be treated as a new corporation and utilize the 31-month safe harbor to qualify as a QOZ business. The alternative would be for the operating entity to transfer its assets to a new subsidiary and have the QOF invest in the new subsidiary, which would be a totally unnecessary step.

H. Tax Status of an Existing Entity.

Some existing startup businesses might be C corporations for federal income tax purposes to attract venture capital dollars. Consideration should be given to whether continuing C corporation status presents tax inefficiencies and the tax cost or reasons against converting to an LLC.

A QOZ requirement is the "nonqualified financial property" limitation that permissible cash held by such entity be less than 5% of the unadjusted tax basis in the property of a QOZ business. Points for consideration on this point are (1) what properties can be taken into account against which the 5% limit applies, (2) the feasibility to convert the C corporation to an LLC to allow future net operating cash to be distributed in a tax efficient manner., (3) developing financial projections illustrating whether C corporation will have earnings for federal income tax purposes and whether distributions will result in taxation to the investors in the QOF based on amounts exceeding tax basis, and(4) whether excess cash amount will distributed to investors in the C corporation other than the QOF.

I. Structuring.

If the above points can be addressed favorably, the 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 operating entity in exchange for an equity interest. Additional financing, as needed, would be incurred at the operating entity level.

J. Exit Strategy.

After the 10-year holding period needed to attain the tax free appreciation tax benefit is met, the investors can then sell their equity interest in the QOF. The preferred approach continues to be the sale of the equity interests in the QOF. Under certain circumstances, the sale of the QOF interest in the operating entity or the sale of the operating entity assets might not be as tax beneficial for the sellers.

With respect to the exit strategy of investments in startup tech companies, there is always the impetus to sell as soon as the inherent value is apparent, which could be earlier than the ten-year point. In such instances where the interests are sold within 10 years, consideration would need to be given to whether the disposition of the equity interests in the QOF can be structured in a manner pursuant to the Round Two Guidance to rollover the appreciation in a manner that allows the holding period to continue until the 10-year period can be satisfied.

All requirements to having a QOZ business must continue to be satisfied throughout the period that the investors want to benefit from the tax free appreciation. All requirements need to be met for at least 90% of the holding period, which provides little room for not satisfying all of the applicable requirements. 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.

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