Tax Notes

Opportunity Zone Funds: Family Office, Private Equity and Venture Capital Structuring Considerations

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The recently enacted Opportunity Zone (OZ) legislation provides for two independent approaches to the basic investment proposition: ownership of OZ fixed assets (typically real estate) versus ownership of operating businesses located in the subject zones. And although the former has thus far received the lion's share of attention, ownership of OZ businesses will often provide a more compelling overall investment proposition. Pending further guidance, however, uncertainties remain.

In this third article of our ongoing series, we will explore certain structuring considerations in the formation or relocation of businesses into an Opportunity Zone.

Beyond Real Estate

In our continuing discussions with investors, promoters, fund managers and other service providers, the initial investment focus typically starts with real estate domiciled within a census tract designated as an Opportunity Zone (OZ). Real estate in economically challenged areas can, under the right circumstances, provide an attractive economic return, particularly if the program succeeds in gentrification of the immediate neighborhood. However, the economic track record of such investments has historically been spotty.

As an alternative, to date we have seen compelling Family Office, Private Equity and Venture Capital models based upon incubating tech start-ups and other large scale operational businesses in designated zones. These models focus on incubating start-ups with potentially national or even global scale, as opposed to owning real estate or smaller scale local businesses there (e.g., a Starbucks or a strip mall). One can only imagine the tax and economic benefits to early stage investors if Facebook or Google had been incubated in an OZ.

OZ Business Investment Mechanics

The OZ statutory framework with respect to smaller local business start-ups is rather straightforward, and we will not spend time on the subject. Instead, we will focus on certain complexities involved in the incubation of larger scale OZ based tech or other operational businesses with the potential for broad geographical reach.

First, we will provide definitions for several key OZ terms, and then incorporate these terms into a brief overview of how the existing OZ statutory framework drives structuring the ownership of OZ-related assets or businesses.

As currently written, the OZ legislation requires that 90% of an OZ fund's assets constitute "Qualified OZ Property" (QOZP). QOZP is comprised of two sub categories:

1. "Qualified OZ Business Property" (QOZBP), which in turn is comprised of two sub-categories:

    a. Direct ownership of an asset in an OZ, typically real estate, ***or***
    b. Direct operation of an OZ business, where the business assets are owned directly by the OZ fund.

2. "Qualified OZ Business" (QOZB), which means an equity investment in an intervening corporation or a partnership, which in turn owns the actual OZ asset or business.

Qualified OZ Business Property (QOZBP) Requirements

With respect to the QOZBP (#1 above), in order for QOZBP to qualify for OZ fund related benefits, the assets must meet three specific statutory requirements in the hands of the OZ fund:

- The assets must have been purchased after December 31, 2017 from an unrelated party,
- Their original use must commence in the OZ, or be substantially improved there, *and*
- They must be used in the OZ for substantially the entire holding period of the fund.

Qualified OZ Business (QOZB) Requirements

With respect to the QOZB (#2 above), in order for the intervening equity investment to qualify for OZ-related benefits, the business engaged in by the intervening entity must qualify as a "Qualified Opportunity Zone Business" (QOZB). Said underlying businesses must meet three specific statutory requirements:

- 70% of its tangible property used in the conduct of the OZ business must constitute "Qualified OZ Business Property" (defined above), *and*
- The underlying business must meet the requirements imposed by two independent Internal Revenue Code (IRC) Sections which are incorporated into the OZ legislation by reference:

    i) Paragraphs (2), (4) and (8) of IRC Section 1397C(b), *and*
    ii) IRC Section 144(c)(6)(B), with respect to eligible businesses.

Structuring Alternatives

What emerges from the brief outline above is that an OZ fund business investment can be structured essentially in one of two ways:

- The assets of the business can be owned directly by the OZ fund, with the fund operating the business directly (1.b. above).
- In the alternative, the OZ fund can own an equity interest in an intervening entity (corporation or partnership), which in turn owns the OZ assets and operates the business (2. above).

Ongoing tax consequences will differ depending upon which of the two approaches is chosen. The advantages versus disadvantages of each approach must be weighed in light of each set of facts and circumstances.

For example, note that subparagraph (2) of IRC Section 1397C(b) is incorporated by reference whenever an OZ fund chooses to hold its OZ business investment through an intervening entity. This subparagraph specifies that a minimum of 50% of the gross income of an underlying OZ business must be derived from within an OZ. This could be problematic where the business model for a contemplated OZ business is one where multiple locations will ultimately be needed. This 50% requirement is not present if the business assets are owned directly by the OZ fund itself. However, recall that cash is not considered QOZP, and the

legislative exception for working capital may offer more flexibility where an intervening entity is utilized. So as referenced above, the advantages of one approach versus the other must be weighed accordingly.

Stay Tuned

Upcoming modifications and/or clarifications to the existing statutory framework are expected in the very near future. It is anticipated that they may very well eliminate some, if not all, of the disparities between operating an OZ business directly versus through intervening entities. In the meantime, investors, promoters, fund managers and other service providers must exercise caution. Tax structuring must incorporate flexibility to allow for adaptation as ongoing guidance continues.

Contact Us

The Financial Services Tax Group at PKF O'Connor Davies is available to assist with all aspects of the new Opportunity Zone legislation. We offer a full slate of structuring, audit, tax, and administration services to Opportunity Zone funds and their investors.

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