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Qualified Opportunity Zones for Startups & Existing Businesses

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LAUNCHING A STARTUP IN QUALIFIED OPPORTUNITY ZONES

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Many startups and existing businesses seeking venture capital don't realize that they could make an investment in their business more attractive by locating or moving it into a Qualified Opportunity Zone (QOZ).

QOZs, designated by the state in which they are located and certified by the U.S. Treasury through the Internal Revenue Service (IRS), were created as part of the Tax Cuts and Jobs Act of 2017. Investors in QOZs can reduce their recognized capital gains tax and eliminate capital gains tax liability from future appreciation of these QOZ investments.

In December of 2019, IRS finalized the QOZ regulations, which provide favorable treatment for both business and real estate uses. While the final regulations did not substantially alter the spirit of the incentive, they did help clarify rules around certain types of eligible gains, reinvestment timing, and working capital issues.

Specifically, QOZs allow investors, within 180 days of a capital gain recognition event, to roll their capital gain dollars into a Qualified Opportunity Fund (QOF), which owns a business located in a QOZ, and defer the taxes on that gain until the earlier of December 31, 2026 or until they dispose of their stake in the fund. By properly structuring their business within a Qualified Opportunity Fund, startups and existing businesses can pass these benefits on to potential investors and make an investment more attractive for a venture capitalist or angel investor seeking to reduce their capital gains tax.

A business in a QOZ must be set up under the umbrella of a Qualified Opportunity Fund. The fund is usually established in the form of a corporation or partnership (including a multi- member LLC), which is self-certified as a Qualified Opportunity Fund.

To qualify, the fund must be capitalized by capital gains within 180 days after the original gains are realized. After a Qualified Opportunity Fund is created, the fund needs to invest a minimum of 90% of its assets in new or existing Qualified Opportunity Zone Businesses.

An Opportunity Zone Business is a second-tier investment vehicle in the form of an LLC or a corporation, which does a certain amount of business and owns a certain amount of property within a designated QOZ.

A qualified business can be almost anything, from a grocery store to a fintech startup, with a few specific exceptions including golf courses, country clubs, gambling facilities and liquor stores.

If an eligible investor holds the QOF investment for 5 years prior to the mandatory 2026 recognition date, their capital gains for tax purposes will be reduced by 10%. Finally, any additional gains (i.e. appreciation in the fund investment) realized from investing in a QOZ are not taxable, as long as the QOF investment is held for at least 10 years. Investors can qualify for a permanent capital gains tax exemption on all gains they realized on their QOF investments through 2047.

EXAMPLE

- An investor sells his stock in PayPal (or any other type of appreciated asset like art, classic car, cryptocurrency or maybe even a medical practice) at a $10,000,000 profit.

- In the state of New York, the investor would pay 36.46%[1] tax on a long-term capital gain or $3,646,000 in our example with the sale of PayPal stock.

- Instead, the investor can place the realized gain ($10,000,000) in a Qualified Opportunity Fund that owns a QOZ-qualifying startup business. Provided that the investor keeps the realized gain in the QOF for five years, the capital gains tax on the PayPal stock sale will be levied on $9,000,000 (10% step-up in tax basis) instead of $10,000,000 which results in $365,500 tax saving

- Most importantly, if the investor holds the same $10,000,000 investment for more than 10 years and disposes of it, for example, for $25,000,000, he will not have any tax obligations on the gain of $15,000,000. Yeap!

This has obvious benefits for startups seeking capital, making start-ups that are set up in a QOZ substantially more attractive to investors. However, existing businesses can also take advantage of QOZs by moving into one of these zones.

As an example, an existing biotech company (a Delaware C-Corp), which has already undergone an initial seed round, is now considering relocating to a QOZ in New York to make their next financing round more attractive to investors. In this example, the biotech company can be incorporated in Delaware, do business in New York and take advantage of QOZ program.

[1] This example assumes a federal tax rate of 23.8%, including the 20% tax rate on long-term capital gains and the 3.8% net investment income tax, a state tax rate of 8.8%, and a local tax rate of 3.86%, and that gains are not offset by capital losses, credits or deductions. Source: Citizens Budget Commission (https://cbcny.org/research/opportunity-zones-new-york-state-and-city).

To qualify as an Opportunity Zone Business, the company must meet, among other things, the 50% gross income test, which requires either of the following:

- more than 50% of services are performed within the QOZ, based on hours of employees or contractors;
- more than 50% of services are performed within the QOZ, based on amounts paid to employees or contractors;
- more than 50% of income is generated by tangible property located in a QOZ and by management or operational functions, performed in the QOZ.

In practice, it means that a startup with a head office outside the QOZ is eligible if 50% of its payroll is paid to employees who are working within the Opportunity Zone. In the same way, a company with headquarters inside the Opportunity Zone is also eligible, regardless of whether the income is generated inside or outside the zone.

Other criteria for a company to qualify an Opportunity Zone Business are:

- more than 70% of its tangible property is Opportunity Zone Business Property, as defined below;
- more than 40% of its intangible property is used in the active conduct of business within a QOZ, which applies, for example, when a company decides to sell its franchise;
- less than 5% of the assets are attributable to the nonqualified financial property, such as stocks, debt futures, or similar.

So, in the above example, if the biotech company locates 50% or more of their employees and independent contractors within a Qualified Opportunity Zone, they will meet the threshold and would be considered an Opportunity Zone Business. They could then establish a separate Qualified Opportunity Fund to receive investments, which could then purchase stock in their company, allowing the investors to reap the tax benefits afforded by the program.

Opportunity Zone Business Property must be bought or leased from unrelated parties after December 2017 and used for the trade or business within a QOZ. Most importantly, the original use of the property must begin with the operating entity or, in the case of existing property, should be substantially improved within 30 months after the date of acquisition, which in practice means the business should spend as much money on improvements as was spent on the real property's acquisition.

Finally, the company must engage in the active conduct of a trade or business, which implies that it can't just buy a building, sit in it for several years, sell and get tax deferment.

SUMMARY

Seeking to spark innovation and bring investment to economically distressed areas of the U.S., the 2017 Tax Cuts and Jobs Act has provided several tax incentives for investing in QOZs.

QOZs have been designated throughout the United States, but those in New York and California may be uniquely attractive to both startups and investors interested in minimizing their tax liability.

For example, in New York City, the state has designated QOZs in portions of promising areas of the city, such as parts of:

- **Midtown West in Manhattan (perimeter from 10th to 12th Avenue; from West 50th to 58th Street) – area where many hedge funds are moving to;**
- **The Lower East Side and Upper West Side in Manhattan;**
- **Bushwick, Greenpoint, Williamsburg, Bedford-Stuyvesant, Coney Island in Brooklyn; and**
- **South Queens and Long Island City.**

Startups and existing businesses wishing to take advantage of these benefits and locate their businesses in communities that are ripe for growth, should consult with an experienced attorney and tax advisers to develop a clear strategy for structuring their business model to capture the benefits afforded by Qualified Opportunity Zones.

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Dilendorf & Khurdayan offers practical and effective legal solutions to innovators and visionaries in the venture capital and startup industry looking to invest in and launch startups in Opportunity Zones.

Our firm is the go-to expert for all matters concerning set-up of new businesses in Opportunity Zones. Clients rely on us for program updates and comprehensive legal analyses, keeping them on the cutting edge of the program.

Our clients – entrepreneurs, FinTech startups, established businesses, individual investors, private funds, family offices, real estate owners and operators.

We guide these clients through their full business cycle of investing and forming new businesses in Opportunity Zones, including fund formation, ongoing tax compliance and handling general corporate matters.