

# **Bond Case Briefs**

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## **High-Tech Start-Ups Get Relief From Latest Opportunity Zone Proposed Treasury Regulations.**

Qualified Opportunity Zones (“QOZs”) are low-income population census tracts situated in urban, suburban or rural areas that have been specifically designated as QOZs by the governors of the various states and U.S. territories in which such QOZs are situated, and certified as such by the U.S. Treasury. The legislative framework for QOZs was added to the Internal Revenue Code by the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017. The QOZ legislation is designed to incentivize the migration of equity capital into QOZs for purposes of the formation and establishment of new businesses, the development and redevelopment of real estate, and other forms of economic stimuli, with the ultimate goal of job creation and poverty reduction in the QOZs. On Wednesday, April 18, 2019, the Internal Revenue Service (the “IRS”) released the long-awaited second set of QOZ Proposed Treasury Regulations (the “New Proposed Regulations”) relating to QOZs and qualified opportunity funds.

In response to requests made by the many and varied special interest groups that submitted comments to the first set of QOZ Proposed Treasury Regulations issued on October 19, 2018, the New Proposed Regulations – among many other things – attempt to level the playing field as between real estate-centric businesses physically situated inside the applicable QOZ, e.g., a professional office building or shopping center or municipal parking garage, versus start-up businesses that do have a physical presence inside the QOZ but where the majority of sales are to customers situated outside the boundary of the QOZ. By way of example, a non-real estate-centric business could be a start-up business that develops computer software applications where the customer base is global in scope and the customers purchase the computer software applications through internet download by way of an Amazon-like portal. In the case of real estate-centric businesses, gross income is inherently sourced inside the physical geographic confines of the applicable QOZ. In the latter case, where the customers purchasing the ‘intangible’ QOZB products via internet download are primarily situated outside the physical geographic confines of the applicable QOZ, gross income is inherently sourced outside the physical geographic confines of the applicable QOZ.

Before the issuance of the New Proposed Regulations, QOZ businesses (“QOZBs”) were required to generate at least 50% of their gross income inside the physical geographic confines of the QOZ – an income sourcing rule that stopped at the boundaries of the particular census tract in which the QOZB is situated. For real estate-centric QOZBs, this 50% of gross income sourcing rule did not present a problem because the gross income attributable to such QOZBs is inherently sourced within the applicable QOZ. On the other hand, QOZBs with substantial sales to customers situated outside the physical geographic confines of the applicable QOZ had little to no chance of complying with the 50% of gross income sourcing rule because the gross income attributable to such QOZBs is inherently sourced outside the physical geographic confines of the applicable QOZ. The New Proposed Regulations provide three alternative safe-harbors – and a separate ‘facts and circumstances’ test – designed to permit non-real estate-centric QOZBs to demonstrate sufficient nexus to the QOZ in which such QOZBs are situated so as to satisfy what in each case amounts to an alternative test as a replacement for the 50% of gross income sourcing rule, i.e., a QOZB only needs

to satisfy one of the three alternative tests – or the separate ‘facts and circumstances’ test — to qualify.

First, the New Proposed Regulations permit a QOZB to qualify if at least 50% of the services performed (determined by reference to hours worked during the applicable tax year) by employees and/or independent contractors (and employees of independent contractors) of such QOZB are performed within the physical geographic confines of the QOZ. The formula for determination of whether or not the first safe harbor is attained is the fraction (expressed as a percentage), the numerator of which is the aggregate hours worked by employees and/or independent contractors (and employees of independent contractors) of the QOZB where the services are performed within the physical geographic confines of the QOZ, and the denominator of which is the aggregate hours worked by all employees and/or independent contractors (and employees of independent contractors) of the QOZB without regard to geography.

Second, the New Proposed Regulations permit a QOZB to qualify if at least 50% of the services performed (determined by reference to amounts paid for the services performed during the applicable tax year) by employees and/or independent contractors (and employees of independent contractors) of the QOZB are performed within the physical geographic confines of the QOZ. The formula for determination of whether or not the second safe harbor is attained is the fraction (expressed as a percentage), the numerator of which is the aggregate amount paid to employees and/or independent contractors (and employees of independent contractors) of the QOZB where the services are performed within the physical geographic confines of the QOZ, and the denominator of which is the aggregate amount paid to all employees and/or independent contractors (and employees of independent contractors) of the QOZB without regard to geography. Third, the New Proposed Regulations permit a QOZB to qualify if at least 50% of the gross income of the QOZB is ‘deemed to be sourced’ in the applicable QOZ based on a conjunctive test determined by reference to (i) situs of tangible property within the physical geographic confines of the QOZ; and (ii) the performance of services critical to the ‘management and control’ of the QOZB, where such services are performed within the physical geographic confines of the QOZ. The third safe harbor is attained if the foregoing clauses (i) and (ii) are each necessary to generate 50% of the gross income of the QOZB.

Lastly, if a QOZB cannot satisfy taxpayers any of the foregoing three (3) safe harbors, then the New Proposed Regulations permit a QOZB to qualify if, based on the totality of the facts and circumstances, at least 50% of the gross income of the QOZB is ‘deemed to be attributable’ to the active conduct of a trade or business in the QOZ. The New Proposed Regulations are not entirely clear as to how this separate ‘facts and circumstances’ test works but the IRS has requested further comments on this and on the foregoing three (3) safe harbors.

by Mark Wisniewski

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