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A Google in Newark? VCs Hit Snag in New Tax Break for Poor Areas.

- **IRS proposal on income may bar startups from opportunity zones**
- **Investors say many high-growth businesses won't meet threshold**

Dan Borok got excited when last year's Republican tax overhaul included a provision that stood to help his venture capital firm pursue its mission of funding businesses and creating jobs in Newark, New Jersey.

Then came the fine print.

Borok said he was stunned earlier this month by a long-awaited Treasury Department proposal detailing how taxpayers qualify for special breaks by investing in low-income areas throughout the U.S. While the guidelines are generous to investors, buried in the rules is a clause that could deter venture capitalists — and investment in businesses that could stimulate those downtrodden neighborhoods.

One of the rules requires that businesses generate at least half their gross income within the distressed community or "opportunity zone" in which they operate. That's fine for, say, an apartment building or a grocery store, but a disaster for a business hoping to manufacture a product to be sold widely, or provide services online.

Borok's firm Newark Venture Partners has backing from Amazon.com Inc.'s Audible unit, Prudential Financial Inc. and several other prominent firms with offices in the New Jersey city. He worked for Google in the early 2000s, a company he says would never have met the 50 percent income test.

"None of the revenue came from Mountain View," he said, referring to the Silicon Valley city where the search-engine giant is headquartered. For a lot of high-growth businesses, "their customer base is not where the company is."

The clause seems to be at odds with the intent of the legislation, which is to attract private capital to roughly 8,700 disadvantaged economic areas and create jobs. Treasury Secretary Steven Mnuchin has suggested that $100 billion could flow to opportunity zones. The Economic Innovation Group, a Washington think tank that helped push the idea, has called the incentive the most ambitious effort to spur investment in low-income areas in a generation.

The tax breaks are especially attractive for people looking for ways to minimize levies on capital gains. Investors can plow proceeds from the sale of a business, stock or other asset into opportunity funds, deferring those taxes until 2026 — and potentially reducing their liabilities by as much as 15 percent. If the funds buy and hold qualifying businesses or property in opportunity zones for at least a decade, investors can avoid paying capital gains on any of the fund's appreciation altogether.

'Unintentional Consequence'

Such incentives should be a natural fit for investors looking to take their winnings from a tech startup and deploy it in another one located in an opportunity zone. But the Treasury regulations will hurt high-growth startups, which tend to generate most of the net new jobs, according to Steve Case, the AOL co-founder whose firm Revolution LLC has focused on seeding companies outside well-established tech hubs.

In July, Case hired two real estate executives to help make direct investments in opportunity zones. Before the legislation passed, Case was also a prominent backer of the tax breaks.

"I hope the Treasury Department will see the unintentional consequence of this new restriction and amend it in the final rules," Case said in a statement.

So far, the most interest and activity in opportunity zones has come from the real estate industry. Some of the highest-profile firms that are wading into the market — from Goldman Sachs Group Inc. to hedge fund EJF Capital — have plans to use the tax breaks to develop buildings.

"One of the fears that many have is that this incentive will end up being predominantly used" to invest in rental properties, said Michael Novogradac, a specialist in tax breaks for low-income housing, community development and renewable energy. If the gross-income requirement isn't changed, "it'll definitely restrict the number of operating businesses in opportunity zones that benefit from the incentive."

Old Tax Code

The backlash against such a small detail in a document that ran dozens of pages shows the difficulties regulators face as they rely on guidelines and definitions in the old tax code to implement the new law's provisions. The legislation left open a lot for interpretation, forcing regulators to fill in gaps and sparking criticism about who will ultimately benefit.

Even before the proposed regulations were released, researchers and nonprofits argued the opportunity zone provisions were written so broadly that savvy investors and real estate developers could exploit them for projects they might have done anyway or that displace lower-income residents. There's also no requirements for businesses to hire employees from within the zones or benefit the communities more broadly.

Treasury is currently studying the gross-income issue, collecting information and hearing from stakeholders, according to an official. The department is committed to swiftly issuing sound regulations that best serve communities and investors, the Treasury official said.

Potential investors welcomed most of Treasury's other proposed regulations related to opportunity zone businesses. One of them stipulates that only 70 percent of a company's tangible property has to be in a designated area, a threshold that an official previewing the regulations earlier this month for reporters said was favorable. Many investors, accountants and lawyers following the regulatory process were concerned the bar would've been set higher.

'Terrible Economics'

Still, rules like that could be moot if the income requirement stays in the final regulations, said Steve Glickman, chief executive officer of Develop LLC, a consulting firm for investors in opportunity zones, and a co-founder of the Economic Innovation Group.

"I'm not sure they totally realized the impact this is going to have on high-growth business investment," he said. Only allowing local businesses, like hardware stores and restaurants, "sounds like great politics, but it turns out to be terrible economics.”

Treasury is accepting comments on the opportunity zone proposals until Dec. 28. The department is also planning to release a second batch of regulations by the end of the year addressing the ongoing operations of opportunity zone funds.

For now, some investors who hope to use the opportunity zone tax breaks to finance businesses are waiting, hopeful that the income requirement will be revised or eliminated.

“Given what we know about the intent behind this legislation, we feel this is an oversight that will be rectified,” said Peter Brack, managing partner of Hypothesis Ventures, a firm that invests in startups outside California’s Bay Area. “A responsible venture investor would be sitting on the sidelines right now until this is clarified.”

Bloomberg Economics

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October 31, 2018, 1:00 AM PDT Updated on October 31, 2018, 8:07 AM PDT

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