Growing Your Dry-Cleaning Business with Opportunity Zone Incentives

By Gerald J. Reihsen, III

The Opportunity Zone (OZ Law) incentive program introduces multiple tax benefits upon investment of capital gains into "Qualified Opportunity Funds" (QO Funds) which invest in real estate development, tangible non-real estate business property and businesses connected to designated private equity investment funds called Qualified OZ Funds within six months (180 days) after such gains are realized or, with good fortune and careful planning up to 18 months after such gains are realized. These benefits are "nice", "great" and "fabulous"!

- **NICE.** Tax on those invested capital gains (let's call them the OZ Capital) can be deferred up to seven years.
- **GREAT.** The taxable portion of that OZ Capital can be reduced by up to 15% if kept invested for that entire period.
- **FABULOUS.** The investment gains above the original OZ Capital can be tax free if the investment is held ten years or longer!

With more than 8,700 Opportunity Zones spread throughout our country and its territories all of our nation's businesspersons with designs on growing their businesses for possible sale should be taking a close look at leveraging that eventual sale within the Opportunity Zone ecosystem.

Despite the OZ Law having been enacted in the fall of 2017, there has been very little activity yet directed to financing non-real estate businesses within the program. The main reason for this is, while it's coming up on two years since the OZ Law's enactment, the rules for business investment are still being written. The IRS has been diligent in its work on these rules and it has already proposed two sets. However, the OZ Law is novel and the IRS is trying to be sure the rules are reliable, thorough and supportive of the goals of the statute. The expectation is that the proposed rules that have been published so far are very close to the full set and will be subject only to refinement. So, it's time to start planning how businesses can leverage Opportunity Zone incentives and be prepared for the fully nuanced rules to be finalized later this year.

The OZ Law is very flexible. This helps to allow it to be broadly applied across many industries and business models. But it also means that it must be considered with specificity to whatever industry and business model that is to be leveraged. This will almost always mean tweaks to the business structure will be required. The extent of any such tweaks and the cost and effort of compliance with the OZ Law's requirements must be weighed against the benefits.

When thinking about the OZ Law, it helps to visualize the waterfall structure required by the OZ Law. Let's visualize a waterfall that borrows a common drycleaner business model. The visualization on the right shows that it all starts with the Investors that have generated OZ Capital. It is at this level that all of the of the direct benefits apply, the nice, the great and the fabulous.

So, if the benefits are all to the top line Investor, why would a business want to structure to become the bottom of the waterfall Qualified Opportunity Zone Business (QOZ Business). There are three great reasons.

First, competition for growth capital is intense. Those investment opportunities that can bring something extra to their impressive investment thesis have a huge advantage against others seeking capital. An Investor is going to put its capital into a business with tax free upside (among the other OZ Law benefits) before one without that, all other things being equal. And because this capital benefits from the OZ Law incentives it should be lower cost and more patient than other capital sources.

Second, the market is being flooded with OZ Capital and there are a growing number of investment vehicles (QO Funds) that must place capital into Opportunity Zone investments to maintain compliance with the OZ Law.

Third, the Investor can be the business owner and the QO Fund can be an entity created and controlled by the business owner.

There can be a mix of the above considerations as well. For instance, the business owner may create a QO Fund in which the business owner has an interest that is leveraged by taking in third party OZ Capital.

And speaking of flexibility, in the structure above it is important to keep in mind QOZ Businesses do not need to have all of their assets in an Opportunity Zone nor must their revenue come from that zone. The rules as currently conceived permit an QOZ Business to remain compliant with the OZ law so long as (1) at least 70% of the tangible property owned or leased by the QOZ Business is located in an Opportunity Zone and meet certain requirements and (2) at least 50% of the QOZ Business's gross income is derived from the active conduct of its trade or business in an opportunity zone.

The currently proposed rules provide a great deal of helpful flexibility for meeting both of these requirements. For instance, the rules permit the QOZ Business to source its income globally, not just in an Opportunity Zone, so long as it meets certain safe harbors (or otherwise can show) that the income is dependent on its activities in the zone.

So, in the example of the above dry cleaner business model, locating the dry-cleaning plant in the Opportunity Zone can enable multiple pick up stores within practical delivery distance to the plant so long an in aggregate the asset and income tests remain met.

The effect of the OZ Law is that in exchange for investing through its system the federal government provides the investor a loan of up to 7 years of the tax that would have been due on the original capital gains and pays that investor an interest rate of up to 15% - comparable to a negative interest rate loan.

Continued

Opportunity Zones

(Con't)

Further, OZ investing can be much like 401(k) or IRA investing where the investor's capital grows and the growth comes out after 10 years tax free.

Don't try this at home! There are many nuances and limitations under the OZ Law which cannot be addressed in this brief article and non-compliance can have expensive consequences. Consult with good business attorneys who have become expert in the area. But by all means do reach out to those experts. Don't be the one who ignored this once in a generation tax incentive and regrets substantial non-taxed proceeds on the sale of your business ten years from now.

Mr. Reihsen is a business attorney with the law firm of Reihsen & Associates and the founder and chief executive officer of Coasis Coalition Companies PB LLC. Mr. Reihsen's legal background includes business and investment fund formation, corporate structuring, capital formation and investment structuring, and the full range of business transactions, including mergers and acquisitions.

Coasis Coalition's mission is to engage the opportunity zone investment community and opportunity zone residents with support and services that advance their solutions and interests and the goals of the opportunity zone program. Coasis is the organizer of the national Coasis Coalition Opportunity Zone SuperConference held twice per year.

Opportunity Zones Helpful Links

Where are the Zones?

View on map

www.opportunitydb.com/location

View by census tract number

www.irs.gov/pub/irs-drop/n-18-48.pdf

Learn More about Zones

www.coasiscoalition.com

www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions