Additional comments by Girard Miller regarding eligibility of diversified angel and venture capital funds for the 10 year OZB investment gains exclusion (step up in basis)

November 26, 2018

To provide some specific suggestions to Treasury/IRS staff working on revisions to the proposed regulations to recognize the importance of diversified angel and early-stage venture investment funds to startup businesses in opportunity zones, I offer the following comments:

Background and rationale: To expand on a point made in the introduction to my original November 19 comments regarding the nature of investing in startup businesses and the need for diversification as an essential investment principle:

> Unlike most single-site real estate developments, most successful startup businesses expand, many pivot from their original vision and business plan, and some of them relocate out of necessity or because of their success. A high percentage fail, making this a risky asset class for investors but essential for economic development and employment growth. ***Diversification is therefore necessary to attract early-stage investor capital, given the binary risks of startup businesses in the innovation economy. Undiversified, single-purpose or single-investment OZB funds will lack investment merit for most traditional investors in this asset class. Accordingly, the regulations for startup businesses funded by typical angel investment vehicles should be more flexible in design, in order to optimize, channel and target the risk capital provided by this unique investment asset class.***

Managers and investors in diversified angel and venture capital funds will not be able to know in advance the magnitude and percentage of fund investments to be made in qualified opportunity zone businesses. Accordingly, it is simply impractical for them to comply with the regulatory requirements for tax deferral as drafted presently. To the extent that investments must first qualify for tax deferral in order to then be eligible for the ten-year gains exclusion, the regulations effectively preclude investments that would qualify under the regulations.

It therefore appears that the first and necessary step needed in order for angel and venture capital funds to deploy capital favorably in opportunity zones is that the 10-year gains exclusion must be permitted for those funds as a special case, either as an exception, a safe harbor, or by definition. Perhaps the best way to accomplish this would be to start with a definition of the types of funds that would be eligible for this special rule:

“A **Qualified Opportunity Fund** includes ………… a Qualified Diversified Venture Capital Opportunity Fund as described below.” *(this could be a freestanding sentence or an insertion in the currently proposed definition).*

Then:

“A **Qualified Diversified Venture Capital Opportunity Fund** includes a partnership, an investment or personal trust, or a qualifying venture capital fund or angel capital fund exempt from registration under the Investment Advisors act, that invests in more than one business including at least one qualified opportunity zone business in which the fund’s investment interests in the opportunity zone business are recorded in segregated sub-fund accounts and passed through pro -rata to each investor in the fund. In such a fund, only those segregated sub fund interests may become eligible to become a qualified OZB investment”

“Eligibility of investments in a Qualified Diversified Venture Capital Opportunity Fund for the 10-year gains exclusion (step-up) shall not require that they also be eligible for deferrals as provided in ……..”

Because I am not a tax attorney, other technical revisions to the proposed regulations may be needed to assure that the foregoing proposed remedy accomplishes its intended purpose with respect to startup businesses and angel/venture investment funds, but I am hopeful that staff will give favorable consideration to the approach I have constructed above, or an equivalent pragmatic remedy.

Opportunity Zone Businesses qualifications requirements: See your # (5) *Operation of section 1397C requirements incorporated by reference*—(i) *Gross income requirement.* You have also reserved a section for “active conduct of a trade or business.” I would suggest that the 50 percent of gross income test should be only one of several criteria that could be satisfied to achieve eligibility. <u>Other</u> qualifying criteria could include:

- 70 percent of total payroll and contract labor costs, ***<u>or</u>***
- 50 percent of total variable factor inputs or cost of goods sold (including labor, materials, parts/components assembled, production equipment rental, other goods and services, etc.)

As explained in my November 20 comments, you may need to take a point of view on suitable equipment/product assembly businesses, retail outlets and franchise operations including fast food franchises, while drawing a bright line that disqualifies “loophole” businesses that simply “front” in an opportunity zone. Gross income by itself is unlikely to be a satisfactory all-in-one criterion. I believe that the two hurdles suggested above would be sufficient, in combination with your existing gross income test. They are more specific and clearly measurable than the language you have proposed (i.e., “derived from active conduct”).

Investors in particular will be grateful if you can establish some bright line or safe harbor measures, which will greatly reduce uncertainty of regulatory tax risks, especially if there are reasonable alternative paths for compliance in the event of a technical or temporary deficiency with respect to a single measure.

My previous comments regarding allowable time periods and procedures for eligible investors' and funds' capital rollover, etc, remain unchanged and still very important to address.. This secondary commentary is simply intended to provide concrete language to effectuate the solutions originally requested and suggested. I remain thankful for your consideration and look forward to your next iteration. .

Cordially and respectfully,

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