# IRS REG 115420-18

## Comments by Girard Miller, a Laguna Niguel, CA "angel" investor, regarding Opportunity Zones for startup businesses, and angel/venture investment groups

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**Executive Summary:** The proposed Opportunity Zone (OZ) regs overlook the startup and angel investment community as they pertain to qualified OZ businesses. These comments include criteria for remedies and specific suggested provisions, safe harbors and bright line principles to fulfill the legislation's objectives and stimulate the innovation economy.

Recommendations include:
- Specific provisions for angel investment and venture capital funds, especially diversified funds, to pass through the OZ incentives and benefits to their investors in the simplest way possible
- Include convertible notes in definition of "equity" (or incorporate S.E.C. definition)
- Clear safe harbors and/or bright lines for permissible percentages of "extraterritorial" factor inputs employed by an OZ business
- Longer re-investment periods for both QOFs and individual investors
- Safe harbors for redeployment of investor capital if an OZ business becomes disqualified

## Introduction and Background

I am an individual investor located in Southern California, with modest experience as an "angel" investor in startup companies. As such, I belong to several angel groups and am a member of several angel/venture funds that focus on startup businesses. I am also a retired mutual fund executive with prior experience assisting Treasury staff in development of municipal arbitrage regulations, so I have a modicum of professional experience in the challenges you are facing as you seek to implement this promising but incomplete section of the TCJA. My comments are intended to be constructive and suggestive: I am not an attorney nor a tax expert, and therefore assert no claim of special expertise in regulatory word-smithing. I can only tell you here what is needed in order for Opportunity Zone regulations to be effective for small business operators, franchisees and startup business entrepreneurs, and the angel investment community that typically provides equity risk capital to those on the cutting edge of business/industrial/medical/technology innovation.

***The entrepreneurial startup and angel investment communities have been overlooked.*** As presently drafted, the proposed Opportunity Zone regulations focus predominantly on real estate development. Although physical property development will obviously and predictably produce construction employment and space that can be occupied by operating businesses that employ workers, the regulations as presently drafted tend to overlook the potential benefits of opportunity zone tax incentives as they can apply to startup entrepreneurs and small businesses. Research has shown that startup and small businesses create substantial new employment nationwide, so the legislative intent for establishing Opportunity Zones will be much better realized if the regulations are expanded and written to provide clear guidance for the entrepreneurs and investors in small and startup businesses. There are literally thousands of "angel" investors nationwide who provide vital entrepreneurial risk capital for startup businesses. Much of this capital is invested directly by individuals and family offices, and much of it is invested through diversified angel and venture capital funds whose portfolios will typically include companies located mostly outside of the opportunity zones. This equity capital can be effectively leveraged and channeled toward legitimate and gainful Opportunity Zone commerce once the regulations provide clear guidelines and safe harbors that take into account how the startup business community and the venture capital markets actually operate presently.

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.

Although the proposed regulations attempt to provide a broad framework for Qualified Opportunity Funds (QOFs), they need to be revised so that diversified angel investment and venture capital funds can be structured and deployed in order to invest in qualified opportunity businesses as part of their overall portfolio, and pass through the tax incentives to their investor-partners in the simplest way possible without having to proliferate single-purpose undiversified QOFs. The funds and their investors also need to see workable rules for re-employment of capital in the event a portfolio company no longer qualifies because of expansion or relocation or a corporate action such as a merger/acquisition prior to the ten-year required holding period for investors seeking the gains exclusion.

## Improved Regulatory Objectives for Startup OZ Businesses

First, let me say that it is difficult to imagine a scenario in which a typical <u>diversified</u> angel investment fund and its underlying investors could <u>ever</u> qualify for the capital gains "rollover" tax *deferrals and deductions* available for opportunity zone business investment. Structurally, their subscription, funding and investment processes are not designed to accommodate the timing requirements and the regulatory compliance built into your proposed timetables. Only new funds designed expressly and exclusively to invest in QOZ businesses would be likely candidates for tax deferral and I see nothing but confusion, tax evasion and compliance headaches as likely outcomes of any efforts to re-engineer and torque the regs to extend the tax *deferral* incentive to conventional diversified angel funds. That won't be cost-effective. Let's focus instead on what can and should be operationally feasible in the real world of angel and venture fund investors.

I believe it better to simply focus ***instead on the ten-year gain exclusion incentives for angel and venture investors.*** Angel investors are familiar with Section 1202 incentives, so a parallel framework for opportunity zone businesses and funds will have a familiar ring to many in this sector. Accordingly, the regulations with respect to startup and small businesses -- and the investors who characteristically provide equity risk capital to these businesses – should seek to achieve the following objectives:

a. Clarity in how qualified opportunity funds can invest in one or more such OZ business using prevalent investment vehicles. The regulations should provide a safe harbor to permit angel and venture funds that invest exclusively in opportunity zone businesses, but also enable those that invest in diversified portfolios that include some but not all QOZ companies to pass through the qualified tax exemption for fund interests in the qualified businesses to their investors, if held in one or more segregated sub-accounts that each satisfy the 90 percent test. For the diversified funds, regulations must provide appropriate guidelines for the qualifying treatment of investors' shares and interests including tax benefits under a variety of scenarios. These scenarios would include:

- Mergers and acquisitions (exits) that would result in the business subsequently failing to qualify by virtue of the business combination.
- Sale of the fund's interests in a qualified OZ business.
- Expansion of the business into locations that are outside the designated opportunity zones
- Changes in a company's business model that require additional factor inputs (such as parts for assembly, contract services, distribution facilities and personnel, etc) sourced or located outside of the designated zones that would then disqualify the business under the "substantially all" rule.
- Disqualification of a single company's eligibility for tax benefits without impairment of a diversified fund's qualification and the tax benefits of other QOZ businesses held in the fund's portfolio.

b. Clarity in the instruments a qualified opportunity fund can employ with respect to investments made predominantly in startup business operations (as distinguished from real estate development). Clear safe harbors and workable ground rules are needed for angel investment funds, and qualified venture capital funds as they are defined and allowable by the S.E.C. – especially diversified funds that would invest in more than one business as most do presently.
    - As one detailed example, the proposed prohibition of debt instruments is understandable for the regulations contemplating real estate development, but in the case of startup businesses financed by angel and venture capital investors, clarification of the term "equity" is needed: It is commonplace for convertible notes to be employed in the first year or two of operations, in order to attract the preferential growth capital needed to achieve revenue breakeven and issuance of follow-on rounds of stock at prices and valuations that cannot be reasonably determined in the very early days of the company which are often "pre-revenue". Please incorporate either the broader S.E.C. definition used for qualified venture capital fund investments in equity -- or provide a reasonable exception or safe harbor for qualified opportunity fund investments in convertible notes that are frequently issued to investors by startup businesses.

c. Clarity on how subsequent disqualification, relocation, or sale of a qualified business will affect the investors in a diversified qualified opportunity fund, and what re-investment options and realistic timelines are available to the fund without triggering tax jeopardy. Longer roll-over periods will be needed in the angel investment world, because deals located or potentially located in designated zones will be exceptions rather than the rule for most angel investors and their funds, and more time will be needed for angel funds/investors to guide founders and CEOs to the benefits of locating their operation in a qualified zone.

d. Clarity in what constitutes a qualified business operation located in an Opportunity Zone beyond the "substantially all" terminology. Please provide reasonable safe harbors for businesses with respect to ancillary operations, workforce locations and factor inputs including equipment and technology platforms and component parts, that recognize that some reasonable portion of their products and services may be sourced outside of opportunity ones, while preventing/disqualifying/discouraging tax sham operations that "front" in opportunity zones with a token presence. A regulatory requirement that relies primarily on your proposed "substantially all" framework is conceptually a good place to begin and would be nice in a world without con artists and tax dodge promoters, but "bright lines" and "safe harbors" are needed in order to provide higher levels of certainty to legitimate entrepreneurs, investors and fund managers who purposely avoid ambiguity and contingent liabilities for tax law violations. Uncertainty on this key definitional issue will be chilling to many investors and their fiduciaries.

- As an example, a medical device technology startup would likely expand its assembly operations soon after its product becomes viable in the marketplace. What percentage of its component parts can be manufactured offshore, or even locally but immediately outside the opportunity zone? Then, should domestic (but non-OZ origin) parts and factor inputs be treated differently from offshore outsourcing? Will a startup software company making an initial growth-stage investment in outside sales personnel become disqualified at a key stage of its expansion? Would employees residing in the OZ qualify the business even if their work location is outside of the zone but adjacent to it?
- You may also need to consider the type of business and the levels of employment it generates. Is a new local fast food franchise operation to be subject to the same metrics as a high-tech light industrial assembly operation such as a breakthrough medical instrument business? What about "big box" retail businesses that simply sell goods produced elsewhere? I am not advocating an industrial policy here, but you should perhaps consider unintended consequences more carefully, as you have already done with your list of disallowed "sin businesses".

Although principles-based regulation is laudable and often desirable, the problem for startup business entrepreneurs seeking investment capital from angel investment groups, family offices, and qualified venture capital funds is that the risk of disqualification of an entire fund will have a chilling affect on investment. In most cases, the liability risk of uncontrollable adverse future tax treatment is unbearable to angel investment groups/funds (which are typically voluntary investment associations or "clubs" with member investors who form partnerships and/or make individual investments), their fiduciaries, and to compensated advisors of qualified early stage venture capital funds. Accordingly, a workable set of safe harbors for Opportunity Zone Businesses (and QOZ Business-focused Funds as distinguished from real estate development focused funds) is sorely needed, in order that traditional innovation-capital providers in this sector can confidently proceed to assemble and operate qualified opportunity funds that can focus predominantly on innovation and expanding businesses in designated zones (as distinguished from real estate development).

To this end, I offer the following suggestions for guidance, clarifications, requirements and safe harbors that would be essential for angel investors and the startup community to successfully deploy the Opportunity Zone strategy more productively, and to advance the legislative intent.

## Suggested Clarifications, Requirements, Bright Lines and Safe Harbors

1. It would be helpful to state expressly that **a qualified opportunity fund may invest in one or more qualified OZ business (but not exclusively, in the case of angel and venture funds).** Likewise, please clarify that a qualified opportunity fund that invests in an operating business may include a trust, a partnership, a closed end fund, an open-end investment fund, **a qualified venture fund, an angel investment fund or partnership , or a continuously re-offered closed end fund.** Some tax lawyers

believe that the proposed regulations already address these points, but lay readers in the angel investment community are far less confident, which will impede investments in qualified businesses. Presently there is far more attention given to defining eligible investors than to eligible funds.

2. As noted above, regulations that clearly allow for **diversified funds to invest in OZ businesses as a qualifying segment of their portfolio** and pass through the gain exclusion pro-rata to investors will be needed in order for the angel investment community and venture capital industry to participate whole-heartedly. It will be very difficult for the angel investment community to establish and operate "OZ-focus" funds that invest only in qualified opportunity zone businesses**. For diversified angel and venture capital funds, a clearly permissive "sub-fund" pass-through safe-harbor feature could be the single most important regulatory provision you can insert**, in order to explicitly encourage investment in startup businesses located in these zones on a national basis, and it could actually stimulate new interest in angel investing nationally in ways that benefit the entire innovation economy. Please facilitate and encourage the use of the existing diversified investment fund infrastructure for startup businesses and early-stage or growth equity venture funds. Under this regime, a qualified OZ sub-fund would be accounted for separately with all partnership interests ratable on the same terms as the remainder of the fund. Each sub-fund would of course be subject to the 90 percent test that applies to all QOFs.

3. Notwithstanding other regulations describing equity investments, allow **a qualified opportunity fund to invest in convertible notes** issued by a qualified opportunity zone business, provided that the notes must convert to equity during the expected investment holding period. Alternatively, these regulations should adopt or incorporate the S.E.C. definition of equity as applied to venture capital funds, which defines "equity" to include the various forms of securities convertible to stock, including convertible notes and warrants.

4. As the regs are now written, a qualified opportunity fund may re-invest partner or investor capital derived from the sale of qualified business holdings, but **the proposed reinvestment periods are too short**. A longer time period than currently provided is needed, to avoid suboptimal reinvestments driven by the calendar more than investment merit. I suggest that such reinvestments must close within twelve (12) months in order for those proceeds to remain a QOZ fund interest. If this capital cannot be reinvested timely, the fund must return those proceeds to the investor/partner who may then reinvest the proceeds in another QOF within 270 days in order to remain eligible for the 10-year gains exclusion. These interim roll-over periods should not count toward fulfillment of the ten-year investment holding period requirement. Only capital actively at-risk should be allowed to fulfill the holding period requirement.

5. **If a fund invests in more than one business, and a given opportunity zone business in its portfolio becomes disqualified** for reasons beyond control of the fund, it may liquidate or sell its interest, and/or distribute its equity interest in that business to investors, within six (6) months, or simply retain its interests without OZ tax benefits for that specific company, without disqualifying the fund or its remaining portfolio. If an angel investment fund holds a QOZ business that subsequently becomes disqualified for any reason, and the fund is unable to liquidate and distribute its equity position to its investors, then the tax benefit should be forfeited without disqualifying the fund from qualified pass-through of other OZ businesses' (sub-fund) capital gains exclusions.

6. **Provide clear safe harbors and/or bright lines for the maximum "ex-OZ" factor inputs that can be employed/deployed by a qualified OZ business and still comply with the "substantially all"**

**requirement**.  For example, what percentage of production ***and*** the materials, parts, components, goods, labor, contract employment and services integral to production or operation can originate outside the zone, as a percentage of sales/COGs/total expenses? (You can pick, or perhaps allow any one of these three measures as the base for calculations.)

Without suggesting "industrial policy", perhaps such safe harbors should be allowed only for certain types of businesses based on their value-added or local employment or economic impact?  For example, a local retail business or franchise operation might best be treated differently (for "OZ content" requirements) than manufacturing and other businesses that produce/assemble locally but market predominantly outside of the OZ.

7.  **Include a workable safe harbor to permit investors to restructure or redeploy capital invested in a QOZ business** that (a) "outgrows" its opportunity zone, or (b) must relocate to remain competitively viable, or (c)  changes its business model,  in a way that takes into account the time period of the investor's qualified investment in fulfillment of the holding period requirements.  Such a provision would enable angel investors and funds to include terms in their contracts that would facilitate or trigger the bifurcation or mandatory spin-off of a qualified or non-qualified business to maintain compliance (or mandatory liquidity rights) in such scenarios.

If you wish to refer questions to me, or discuss my comments, you may contact me at girardmiller@gmail.com.