The Promise of Opportunity Zones for Franchise Businesses

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Since Congress passed the Tax Cuts and Jobs Act (TCJA)\(^1\) in 2017, the phrase “opportunity zones” has become a buzzword in conversations among entrepreneurs, attorneys, politicians, and community leaders. The opportunity zone laws, codified in Internal Revenue Code (Code) sections 1400Z-1 and 1400Z-2, were designed to reward certain investors who bring new investment—including franchise business investment—to designated low income areas.\(^2\) Offering tax incentives to support investment in low income communities is not a novel policy—indeed, similar federal\(^3\) programs like the New Markets Tax Credit\(^4\) and Empowerment Zones have existed for over twenty years.\(^5\) But the opportunity zone offering is distinct: it is an uncapped tax deferral and exclusion incentive with minimal reporting requirements.\(^6\) Although certain questions remain regarding the implementation of the laws, some investors

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\(^1\) Many of the changes to the Internal Revenue Code (I.R.C.) purported to promote investment and development, such as incentivizing companies to repatriate cash held offshore and reducing the federal corporate income tax rate.

\(^2\) All summaries and descriptions of the opportunity zone program are based on Code sections 1400Z-1 and 1400Z-2, the proposed Treasury regulations released on October 19, 2018, and April 17, 2019, and Revenue Ruling 2018-29.

\(^3\) The opportunity zone incentives are relevant to federal capital gains taxes. While some states have passed laws—or are expected to pass laws—to mimic the federal scheme at the state level, many others are not expected to do so.

\(^4\) The opportunity zone laws actually borrow the very definition of “low-income community” from the New Markets Tax Credit (NMTC) law, as codified in I.R.C. § 45D(e).

\(^5\) Lawmakers may have intended the opportunity zone legislation as a kind of extension of the NMTC which is set to expire at the end of 2019.

\(^6\) The NMTC, in contrast, does not have an unlimited allocation. Through 2018, the Community Development Financial Institutions (CDFI) Fund in the Department of the Treasury has awarded $54 billion in allocations. [CDFI Fund’s Year in Review 2018, Community Development Financial Institutions Fund 29, https://www.cdfifund.gov/Documents/CDFITO2_YIR18_Final508_20190321.pdf] The CDFI program also requires detailed reporting.

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have already raised and deployed funds based on the proposed regulations promulgated by the U.S. Department of the Treasury (Treasury). Treasury has indicated\(^7\) that there may not be another round of proposed regulations, sending an encouraging message to the business community to move forward with the information currently available.

The opportunity zone laws were crafted to incentivize investors to unlock capital gains on their balance sheets and guide those funds toward new investments in low-income areas. But the investment community is not homogenous, and the various elements within that community may respond differently to the same set of opportunities. This note will focus on the ways different types of franchise-business investors may be impacted by the opportunity zone laws—if at all. Although opportunity zones offer great promise, it is important to parse the opportunities in order to understand who can ultimately benefit and how they can position themselves to make good investment decisions. A better understanding of the law’s incentive structure can help guide franchisees, franchisors, and franchise-business advisors towards greater engagement with the new laws.

Part I describes the new opportunity zone legislation and its incentive structure. Part II presents examples to demonstrate how franchise businesses can benefit under the law. This section also references several provisions in the Code and regulations that may be relevant to franchise businesses. Part III examines the obstacles faced by franchise-businesses eager to enjoy the opportunity zone incentives and the fact that the new laws may ignore many of the businesspeople who are well-positioned to advance the goals of the legislation. Finally, Part IV proposes potential solutions to those challenges. By considering the needs of franchise managers and investors, legal advisors, and trade groups can fill some of the gaps that currently exist between the laws and the particular needs of investors.

**I. Internal Revenue Code Sections 1400Z-1 and 1400Z-2**

The opportunity zone legislation, codified in Internal Revenue Code (IRC) §§ 1400Z-1 and 1400Z-2, grants capital gains deferral or exclusion to certain investors making long-term equity investments in designated census tracts throughout the United States. The concept for the program was initially developed by a bi-partisan\(^8\) group of members of Congress, although the laws were ultimately passed by a partisan Congress. Consistent with IRC


§1400Z-1, the Secretary of the Treasury worked with the leaders of each state and U.S. possession to determine which census tracts would be designated “qualified opportunity zones” (QOZs). To be eligible for designation, a census tract needed to have a poverty rate above a particular benchmark or a median family income below a certain level. After months of negotiations inside state governments that likely involved significant horse-trading by politicians and special interest groups, all QOZs were selected and announced.

One of the criticisms of IRC §1400Z-1 has been the threshold for census tract eligibility. Some critics have noted that the definition of “low-income community” used in the laws allowed Treasury and state officials to exclude from designation many of the country’s poorest areas. According to the law, a census tract is “low-income” and thus eligible for designation if it has a poverty rate of at least twenty percent. This definition has resulted in surprising outcomes. First, a wealthy residential area with a low-income housing project that constitutes twenty percent of the population might contain an eligible tract, allowing new luxury real estate developed for high-earners to qualify for tax benefits in that area. In Manhattan, for example, designated census tracts became eligible because of large public housing projects that occupy small parts of certain tracts. Second, a thriving commercial area might be eligible if all or most of the sparse residential property in the census tract is lower-income. For example, in Newark, New Jersey’s largest city, certain QOZs are comprised mostly of commercial property and raw land. This situation has allowed the few residences in these areas to determine eligibility for QOZ status. Certain tracts have thus received designation even though important and successful properties such as the Prudential Center and a Courtyard by Marriott are located inside them. Although this situation is not representative of the approximately nine thousand QOZs that were designated under the law, census tracts like these will likely draw an outsized share of the invested capital and news-worthy projects in the coming years.

IRC § 1400Z-2 and the associated proposed regulations describe the tax deferral and exclusion available to qualifying investors, including the much publicized benefit: one hundred percent capital gains tax exclusion for qualifying investments held for ten years or more. To qualify for the benefits, investors must invest in a “qualified opportunity fund” (QOF), defined as

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9. See I.R.C. § 1400Z-1(c)(1). The laws also allow for somewhat relaxed standards for a limited number of QOZs that are “contiguous with the low-income community that is designated as a qualified opportunity zone.” I.R.C. § 1400Z–1(e)(1)(a).

10. “State governments, which had broad discretion to select from qualifying areas, faced a conflict between selecting deeply distressed areas versus already improving or gentrifying areas that were more likely to provide tax benefits to qualifying investors.” Hilary Gelfond & Adam Looney, Learning from Opportunity Zones: How to Improve Place-Based Policies, Brookings Inst. (Oct. 2018), https://www.brookings.edu/wp-content/uploads/2018/10/Looney_Opportunity -Zones_final.pdf.

11. See I.R.C. § 1400Z-2(c). It is important to emphasize that the benefit does not allow investors to avoid income taxes throughout the term of the investment from operating income from the business.
“any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least ninety percent of its assets in qualified opportunity zone property.”12 Qualified opportunity zone property can be “qualified opportunity zone business property” (QOZBP), stock in a corporation that qualifies as a “qualified opportunity zone business” (QOZB), or a partnership interest in a partnership that qualifies as a QOZB.13 QOZBP means tangible property used in a QOF’s trade or business as long as the property was acquired after 2017, the QOF was the first owner to use the property in the QOZ, and during most of the QOF’s holding period and substantially all of the use of such property was in the QOZ during most of the QOF’s holding period.14 Instead of engaging in a trade or business directly, a QOF could own whole or partial interests in QOZBs that engage in a trade or business. Interestingly, the QOF will face differing requirements under the law depending on whether it structures its investments through a QOZB or owns them directly within the QOZ. For example, the proposed regulations prohibit QOZBs from engaging in certain types of businesses such as massage or suntan services (businesses that might be attractive to franchisees).15 However, no such restrictions were put in place for businesses owned by QOFs directly. Another example pertains to the working capital safe harbor, discussed later. While the proposed regulations allow a QOZB to hold most or all of its assets in cash for a period of time as long as that cash is being spent in accordance with a working capital plan—put in place to build the property or business being developed by the QOZB16—no such allowance seems to exist for a trade or business owned directly by a QOF.

To fulfill its ninety-percent “good” asset requirement, a QOF must (1) purchase those assets from unrelated parties,17 (2) close on the purchase after December 31, 2017,18 (3) ensure that either (a) the original use of such property in the QOZ commences with the QOZ19 or (b) the QOF substantially improves the property, and (4) ensure that substantially all of the use of such property is in a QOZ.20 QOFs can increase flexibility by investing in QOZBs—for example, the QOZBs can benefit from the working capital safe harbor and from their own ability to hold a certain percentage of

12. I.R.C. § 1400Z-2(d)(1). The proposed regulations clarify that this means a corporation or partnership for federal income tax purposes.
14. See id. § 1400Z-2(d)(2)(D). The April 2019 proposed regulations clarify the meaning of the various instances of the term “substantially all.”
18. Id.
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assets that are not QOZBP.\(^{21}\) However, while the proposed regulations allow “flow through” benefits to partners in a QOF—the ability for them to benefit from the QOZ tax benefits when the QOZ sells assets instead of when the partner sells its partnership interest\(^{22}\)—these benefits do not appear to apply when QOZBs sell assets. This is important for up-front structuring of QOZ investments because a QOZB developing valuable assets (car washes, for example) could not necessarily sell those assets after ten years and allow the ultimate investors to reap the QOZ tax benefits. Rather, the investor would need to sell all or part of its interest in the QOF or, under the proposed regulations, the investor might benefit if the QOF sells all or part of its interest in the QOZB. However, if the QOZB sold the car washes it had developed ten years earlier, the investor might have to pay the corresponding capital gains tax.

Investors and QOF managers face several hurdles in order to benefit from the QOZ tax incentives. First, investors need capital gains.\(^{23}\) Many investors, even those with substantial income and wealth, may not have capital gains that they can realize. Second, deferral of the gain realized by those investors to qualify for the opportunity zone incentives cannot extend past tax year 2026, before the end of the ten-year holding period required to obtain the major tax benefits. Even well-capitalized investors do not necessarily have enough liquid assets to pay this potentially substantial tax bill.\(^{24}\) Moreover, taxpayers usually receive wages or investment income around the same time as their taxes are due, allowing them to use those funds to pay their tax bill. But in the case of opportunity funds, depending on the nature of the Fund investments and the strategy, taxpayers may receive few, if any, cash distributions until the QOZ interests are sold after ten or more years. This “phantom” tax liability, due and payable without a corresponding cash receipt by the investor, can be a non-starter for many investors.

The long holding period is another requirement that limits the types of investors who will take advantage of the QOZ incentives. Much or most of the benefits of investing in QOFs accrue only after a ten-year holding period. Many investors cannot afford to leave investments in a QOF for so many years. Investors may have emergency expenses or important life-cycle events to fund in their personal lives, or other investment opportunities to pursue. Moreover, because many investment firms typically structure funds

\(^{21}\) See id. § 1400Z-2(d)(3)(A)(i). Only “substantially all of the tangible property owned or leased” by the QOZB must be QOZBP. Property Treasury Regulations § 1.1400Z2(d)-1(d)(3)(i) clarifies that “substantially all” here means seventy percent.


\(^{23}\) Investors may still participate in capitalizing QOFs with equity investments that do not offset capital gains, but those investments will not qualify for the tax benefits. See Prop. Treas. Reg. § 1.1400Z-2(c)(1)(a).

\(^{24}\) Note that this tax bill will be due without regard to any cash distribution to the investor. Rather, the tax will result from deferred capital gains from a qualifying asset sale or from income allocable to the investor’s interest in the QOF. Cash distributions might follow in the near-term or long-term, or not at all.
around three to five year investment strategies, many investors will need to rethink their portfolio structure in order to accommodate the long-term investment horizon of opportunity fund investments. Market conditions might not be right for an exit from the investment after ten years, so investors will need to be prepared for a hold period several years beyond the ten-year mark to ensure the best possible investment outcome.

The requirement to bring new development to the QOZs also serves as a meaningful obstacle for many investors. Fund investments must be either (1) property whose “original use” commences with the Fund or (2) property that the Fund “substantially improves.” Thus, purchasing and maintaining existing tangible assets in a qualified opportunity zone without a major infusion of new capital will not qualify unless the assets were purchased outside of the QOZ—even right outside—and brought inside. Purchasing a stabilized car-detailing business in a QOZ, for example, might provide stable and consistent cash flow for an investor but will not satisfy the value-add requirement of the law, and the investor will not benefit from the opportunity zone tax benefits. The requirement to substantially improve purchased property changes the risk profile of the project: up-front development costs usually mean a lower return on the fresh capital, or no return at all, for several months or years until the business or real estate is fully operational, stabilized, and profitable. The uncertain timelines also increase risk to investors.

The incentives offered by QOZs are most beneficial to investors with QOZ investments expected to generate astronomical capital gains. Many

25. “Traditional buyout firms, of course, typically aim to acquire companies and sell them within three to five years.” Global Private Equity Report 2019, Bain & Co. 29, https://www.bain.com/contentassets/875a19e26e9e4775942e5b86b084df0a/bain_report_private_equity_report_2019.pdf. As well, the “median holding period is falling as GPs exit an increasing percentage of companies in less than five years.” Id. at 23.

26. See I.R.C. § 1400Z-2(d)(2)(D)(i)(II). For example, a new fleet of trucks or airplanes would qualify. The proposed Treasury Regulations issued April 17, 2019, clarify that buying a business outside of an opportunity zone and moving it into the opportunity zone would qualify under the original use rule.

27. For example, consider a gym franchise located in a QOZ that needs a major renovation. The Code requires that a dollar be invested for each dollar of basis in the asset when acquired by the QOF, setting a high bar for the amount of improvements that need to be undertaken to constitute a qualifying fund investment. See I.R.C. § 1400Z-2(d)(2)(D)(ii). However, Revenue Ruling 2018-29 significantly reduced this burden for real estate investments by clarifying that the dollar-for-dollar requirement would only refer to the “building” portion of the property’s real estate value. Thus, if a Fund were to purchase a $800,000 property that was made up of land worth $480,000 and a warehouse building worth $320,000, the Fund would only need to invest $320,000 in the building to have that property be considered qualified opportunity zone property. Even with the significant reduction provided by the Revenue Ruling, however, this investment requirement is still substantial.


29. If Mark Zuckerberg had seeded his Facebook equity in an opportunity fund (using capital gains funds) and had built Facebook in a QOZ, he might have been able to avoid paying capital gains at an IPO ten years later. Instead, Zuckerberg’s IPO, eight years after founding the firm without the benefit of the QOZ laws, cost him an estimated $1.1 billion in taxes in 2012 alone. Stacy Cowley, Facebook’s Mark Zuckerberg Faces S1 Billion Tax Bill, CNN.Com (Mar. 29, 2013, 10:59 AM), https://money.cnn.com/2013/03/28/technology/zuckerberg-tax-bill/index.html.
private equity firms, inventors, and corporations are working to capitalize on the QOZ laws by creating QOZBs—held by QOFs—that will hold promising pharmaceutical or software products and may benefit from massive tax exclusion upon the sale of all or part of the QOF or an interest in the fund; however, all firms generating capital gains over the long term can benefit. A person or team looking to build a valuable business in the decades to come might decide it is worthwhile to do so in a QOZ so that a potential sale many years into the future can be done without capital gains tax. Although business owners with existing businesses in a QOZ may not be able to benefit directly, they may find investors willing to pay more (and receive a lower projected return) for a piece of their business (structured as a qualifying QOF investment) because of the anticipated tax benefits to the investors.

II. Franchise Business Investments in Qualified Opportunity Zones

The new opportunity zone law requires patient capital and offers benefits that are mostly realized in the long term. Investors and franchise business owners and operators are looking for deals with good fundamentals, focusing on deals that would be feasible even without the tax incentives. Franchisees and investors can take advantage of the benefits directly, without government license or approval, and can bring their unique energies and vision to the designated low-income communities by investing fresh capital and ideas. Many of the regulations are relevant to franchise businesses, including regulations relating to (1) leasing and purchasing business property, (2) the working capital safe harbor, and (3) the fifty percent gross income test safe harbors.

A. Leasing and Purchasing Business Property

New regulations have clarified that leased property counts towards the qualified opportunity fund’s investment requirements. In order to count, the lessee must satisfy requirements, including (1) the lease must be entered into

30. The sale would need to be structured appropriately, as the sale of the QOZ or, in certain cases, of QOZ assets. The sale of assets by a QOZB may not qualify for QOZ tax benefits, as mentioned earlier.

31. An article written by an investment professional at Cadre, a successful real estate investment platform co-founded by Jared Kushner, offered a similar analysis: “We hold the view that the [opportunity zone] program’s tax benefits alone will not lead to successful outcomes for managers or investors.” Charlie Anastasi, Opportunity Zones: Moving from Reaction to Action, Cadre Insights (Nov. 28, 2018), https://cadre.com/insights/opportunity-zones-moving-from-reaction-to-action.

32. The QOZ laws were designed to be accessible. Senator Tim Scott, one of the opportunity zone bill’s cosponsors, said, “[U]nlike other related attempts in the past to help these communities, Opportunity Zones don’t create a new government bureaucracy, and we won’t be tying more hands with red tape.” Joint Economic Committee Hearing, Statement of Senator Tim Scott: The Promise of Opportunity Zones (May 17, 2018), https://www.jec.senate.gov/public/_cache/files/b0b51d0b-19a3-418c-9ed3-c7d2ca3b84ce/senator-tim-scott-testimonypdf. Indeed, investors need only self-certify as an opportunity fund.

33. See Prop. Reg. § 1.1400Z2(d)-1(c)(4)-(8).
after December 31, 2017; (2) the lease must be negotiated at arm’s length; (3) the lessee must not intend to purchase the leased property unless for a fair market value price; (4) in the case of tangible property, during ninety percent of the entity’s holding period, at least seventy percent of the use of the property must be in a QOZ;34 and (5) if the lease is entered into between related parties, certain additional restrictions apply—for example, the tenant may not prepay more than twelve months of rent at any one time. These allowances for leased property are positive developments for franchise businesses since many such businesses rely on leased real estate and equipment.

Purchasing assets may be attractive, however, given the Tax Cuts and Jobs Act’s bonus depreciation rules which allow taxpayers to deduct up to one hundred percent of the cost of certain property35 in the year it is placed into service. This incentive makes a major difference to the investment calculus36 of companies investing in machinery and equipment. Depreciation schedules often extend to ten years or longer, and this accelerated depreciation essentially provides an immediate discount to a company in the form of tax savings.37

B. The Working Capital Safe Harbor

Proposed Treasury Regulations issued April 17, 2019, clarify how investors starting to develop their QOZ businesses can satisfy the requirement that qualified opportunity funds hold ninety percent of their assets in qualifying investments. A franchisee purchasing or starting a business, for example, may have several months or years of research, permitting, and other logistical projects, before deploying all of the necessary capital for the business. The regulations provide that investors may deploy their capital over the course of a thirty-one month period as long as certain requirements are met. As long as they do so, the funds they have raised will be considered “qualifying”

35. See I.R.C. § 168(k)(6).
36. Receiving deductions sooner rather than later increases profits because of the time value of a taxpayer’s money. Taxpayers are also incentivized to accelerate their capital spend because the “bonus depreciation” phases out over time. For example, the one hundred percent deduction becomes eighty percent after December 31, 2022. See I.R.C. § 168(k)(6)(A)(i).
37. A taxpayer with a twenty five percent tax rate, for example, will receive an effective twenty-five percent discount on their capital purchases because of the special deductions. This is because a $1,000 purchase will result in a $1,000 deduction which will reduce the taxpayer’s tax liability by $250. Furthermore, most companies with major machinery and equipment needs tend to finance the bulk of their purchases. Thus, the tax “discount” allows for an effective improvement in the leverage on their new purchases. If the $1,000 purchase considered above were financed with a $650 loan (representing a sixty-five percent leverage ratio), that same loan would represent a much higher leverage ratio of the effective price to the purchaser (eighty-seven percent in this case). Higher leverage in the present low interest rate environment allows for richer investment returns to the purchasers. As if these benefits were not enough, purchasers can also benefit from interest deductions over the course of the loan term, a period of time that can last for many years after the purchase. However, Congress acted to limit the extent of this double benefit by passing I.R.C. § 163(j). See IRS, Basic Questions And Answers About the Limitation on the Deduction for Business Interest Expense (Mar. 8, 2019), https://www.irs.gov/newsroom/basic-questions-and-answers-about-the-limitation-on-the-deduction-for-business-interest-expense.
even though most of the funds are held in cash for a significant period of
time. The requirements include (1) preparing a written plan and schedule for
deploying a reasonable amount of working capital “consistent with the
ordinary start-up of a trade or business for the expenditure of the working
capital assets”;38 (2) substantially complying with that plan and schedule; and
(3) holding the unspent funds in assets described in section 1397C(e)(1).39 In
response to comments expressing concerns about unexpected delays upset-
ting working capital plans, the regulations now allow delays in working cap-
ital distributions to the extent caused by waiting for government action.40

C. The 50% Gross Income Test Safe Harbors

When laying out the requirements for qualifying as a QOZB, Section
1400Z-2(d)(3)(A)(ii) incorporates the requirements of section 1397C(b)(2),
that a qualified business entity must derive at least fifty percent of its total
gross income during a taxable year from the active conduct of a qualified
business in a QOZ. Before the regulations clarified this point, it was unclear
whether the only franchise businesses that could meet this standard were
small food-service establishments since they are some of the only businesses
that could generate half of their revenues from customers in the QOZ itself.
Thankfully, the proposed regulations contain three safe harbors that accom-
modate a broad range of businesses, even businesses that do not derive their
income from QOZ-area customers. Businesses need to meet only one of
these safe harbors to satisfy the test.

The first safe harbor is met if at least fifty percent of the services per-
formed (measured in hours) by the business’s employees and independent
contractors (and employees of independent contractors) are performed
within the QOZ.41 For example, a software company that sells its products
globally via Internet download would satisfy the safe harbor if its employees
and independent contractors (and employees of independent contractors)
work at its offices in a QOZ. If most of the hours that they spend working
on the business are spent within the QOZ, the business qualifies despite the
fact that little or no revenue is derived from within the QOZ itself.

The second safe harbor is met if at least fifty percent of the amount paid
by the business to employees and independent contractors (and employees of
independent contractors) is for services performed in the QOZ.42 For exam-
ple, if a franchisor were to maintain its highest-paid staff at its headquarters
in a QOZ and more than half of the company’s payments to employees and
independent contractors (and employees of independent contractors) went

39. These assets include “cash, cash equivalents, or debt instruments with a term of 18
months or less.” § 1397C(e)(1).
40. “If consumption of the working capital assets is delayed by waiting for governmental
action the application for which is complete, that delay does not cause a failure of this para-
41. Id. § 1.1400Z2(d)-1(d)(5)(i)(A).
42. Id. § 1.1400Z2(d)-1(d)(5)(i)(B).
to those people, the franchisor would satisfy this safe harbor even if the majority of the work-hours are performed outside of the QOZ.

The third safe harbor is met if the tangible property of the business that is in the QOZ and the management or operations function of the business that is in the QOZ are each necessary to generate fifty percent of the business’s gross income.43 For example, if a bakery-franchisee with a large staff of traveling salesmen maintains its headquarters in a QOZ and also stores all of its equipment within the QOZ (trucks, baking equipment, etc.), then it can qualify if the management activity and equipment stored in the QOZ are each necessary to generate fifty percent of the gross income of the business. However, a simple showroom or post office box in the QOZ will not be sufficient to satisfy the gross income test under this safe harbor.

The following examples will help to illustrate some of the IRC § 1400Z-2 regulations that are relevant to franchise businesses:

**Example 1:** Frida, a successful franchisee, owns six barber shops that are all part of a nationally recognized chain. The locations, all within a thirty-minute drive of her home, have become more profitable in recent years as the local economy has trended upward. She wants to help her son, Rick, open three locations of the same brand inside opportunity zones near his home in another state. Rick recently called her to tell her that he received all the necessary approvals from the franchisor and has opened a Qualified Opportunity Fund (Fund) to develop and run the new barber shops. Frida sells her lake house at a $250,000 capital gain44 and within 180 days45 invests46 $250,000 in the Fund and receives an equity interest in exchange. Because under IRC §1400Z-2 this was a timely investment, she may elect47 to defer her tax on the $250,000 capital gain instead of paying the tax in the tax year of the property sale. Assuming Frida does not trigger capital gains recognition by selling or exchanging her Fund interest, she will need to recognize her initial $250,000 gain only in tax year 2026.48 If Frida sells her interest in the Fund for $980,000 after ten years,49 she can elect to bring her basis up to fair market value, eliminating her capital gains tax liability on the gains that she earned from the QOF

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43. Id. § 1.1400Z2(d)-(d)(5)(i)(C).
44. Frida could also have sold stocks or other assets that would trigger capital gains recognition.
46. Frida could also just open an opportunity fund of her own. Taxpayers only need to self-certify as a Qualified Opportunity Fund and then report on the percentage of its assets held in Qualified Opportunity Zone Business Property, using IRS Form 8996. No licensing or qualification-checking is required. Frida’s opportunity fund, however, could not be organized as a single-member LLC unless the LLC elected to be treated as a corporation or partnership for tax purposes. See I.R.C. § 1400Z–2(d)(1) and the corresponding proposed regulations.
47. Frida will make this election on her tax return for the subject tax year, using the simple IRS Form 8949. See 2018 IRS Instructions, IRS Form 8949.
48. There are benefits for investors who make their Fund investments sooner rather than later. First, because the gain from Frida’s initial investment needs to be paid by tax year 2026, investors who invest in Qualified Opportunity Funds sooner get a longer deferral period. Second, if investors invest by the end of 2019, their required capital gains recognition in 2026—on their “initial gain,” $250,000 of gain in the case of Frida—will be reduced by fifteen percent. If they invest after 2019 but before the end of 2021, they will get a ten percent reduction. Assuming Frida invested in 2019, she would only have to recognize $212,500 in gains for tax year 2026. In fact, $37,500 of capital gain would be excluded permanently from federal income tax. See I.R.C. § 1400Z–2(b)(2)(B)(ii)–(iv).
49. This assumes the Fund makes qualifying investments which involve substantially improving existing opportunity zone assets or bringing new assets to the opportunity zone, and maintaining sufficient business activity within the opportunity zone.
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investment. Thus, if she makes the qualifying $250,000 investment in 2019 and receives $980,000 in 2029, ten years later, Frida will not have to pay federal income tax on the $730,000 gain. Assuming Frida were subject to a 20% capital gains rate during the tax year of her asset sale, she would save $146,000 as a result of the investment being a qualified opportunity zone investment.

Example 2: Frank has decided that now is the time to open a fast-food restaurant in the middle of the nearby downtown (located in an opportunity zone). He and his friends self-certify as an opportunity fund (Burger Fund), and the fund creates and contributes cash to a business entity, Burger Co., to open the restaurant. Burger Co. has a written twenty-five-month schedule for the use of its cash to create the restaurant. It plans to use the money to find the right site for the restaurant, lease and equip it for use as a fast-food destination with purchased and leased furniture and equipment, pay the security deposit, obtain franchise and government permits, and hire and train corporate and on-site teams. The unspent funds will be held in assets that comply with the requirements of §1397(e)(1), and those funds will be spent according to the written plan. Even though Burger Fund had quite a bit of time during which most of its assets were not invested in QOZBP, it has complied with the requirements of the working capital safe harbor outlined in the regulations, and the investors are thus on-track to enjoy all of the available tax benefits.

Example 3: Sara is an engineer with an entrepreneurial streak. She and her husband have developed a set of drone technologies—both hardware and software—which allow for swimming pool maintenance to be managed from a remote location. Their business consultants have advised them to franchise the concept nationwide and to consider helping their franchisees to comply with the opportunity zone laws by tailoring their franchise offering in three ways. First, their business-system training will include opportunity zone site selection strategies that focus on operating consistently with the fifty percent gross income test safe harbors. Second, they are providing information regarding entity structuring options. And third, they are designing their fee structure, equipment lease-to-own offering (they will offer all of their patented equipment to the franchisees for lease or sale), and business plan to be consistent with the opportunity zone laws’ requirements. Sara believes that this offering can help franchisees build wealth over the long term, aligning their interests with her aspiration to build a successful global brand. She is hoping the support given to franchisees will make her brand more attractive and help her to attract great partners throughout the United States.

50. See I.R.C. § 1400Z–2(c).
51. Her basis in the investment was initially zero but increased to $250,000 after the tax payment in tax year 2026. See I.R.C. § 1400Z–2(b)(2)(B)(g).
52. This figure does not include the fifteen percent in tax liability reduction on the initial gain that she would enjoy for making the investment in 2019. See I.R.C. § 1400Z–2(b)(2)(B)(iv).
53. Burger Co. intends to be treated as a QOZB and will be subject to the applicable requirements.
54. A qualified opportunity fund must hold “at least 90 percent of its assets in qualified opportunity zone property.” I.R.C. § 1400Z–2(d)(1). But the proposed regulations provide that the designated working capital of a QOZB owned by a QOF will be considered as QOZBP, even though the “substantially all” test is not satisfied as long as the requirements of the working capital safe harbor are satisfied.
55. One example of how a franchisor might facilitate franchisee business development in opportunity zones is by crafting exclusivity provisions that allow franchisees to maintain management and operations offices and equipment storage facilities in another franchisee’s territory if the franchisee can demonstrate an inability to obtain reasonable opportunity zone locations otherwise. Doing this might accommodate a franchisee with a territory that does not include...
Example 4: Gina is under contract to buy a local IT services company. Her business plan includes converting the business into a franchise location of a nationally recognized technical support and IT systems-implementation brand. She also realized that the business sits across the street from a QOZ (the current location is at 626 Broadway and she is looking at vacant office space in a large building within a QOZ at 611 Broadway) and plans to move the business there to benefit from the tax incentives. Although the tangible assets that she is purchasing as part of the business purchase are not new and she does not plan to substantially improve them as part of her acquisition, they can meet the requirements for qualifying opportunity fund investments.56

III. Availability of Opportunity Zone Incentives to Franchise Businesses

As franchise business owners and operators and franchise business advisors consider ways to increase the volume of QOZ investing, they can be more effective to the extent that they think about investor populations in segments and consider the incentives and challenges of each group separately; each has its own distinct abilities, priorities, and experience profiles. Below is a list of some of the most important investor groups relevant to franchise businesses.

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Incentivized to participate as a passive investor in an opportunity fund?</th>
<th>Incentivized to participate as an active investor or opportunity fund operator?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current or prospective franchisees. (Non-institutional.)</td>
<td>Relatively few.1 Even among those willing to give up control to a GP, the ten-year hold requirement, the phantom tax burden in 2026, and the substantial investment requirement are issues that few investors can accommodate. Franchisees without capital gains will not be able to access QOZ tax benefits directly.</td>
<td>Yes. Directing expansion efforts towards QOZs may provide great tax benefits. Area developers will have great opportunities here to tailor new or existing development plans to focus on QOZ locations—especially if the change in location is not material to the forecasted success of the site. Franchisees seeking to avoid any measure of complexity and those lacking capital gains will not access QOZ tax benefits directly.</td>
</tr>
</tbody>
</table>

opportunity zones (or well-located opportunity zones) and allow it to satisfy any of the fifty percent gross income test safe harbors.

56. “Used tangible property satisfies the original use requirement if the property has not been previously so used or placed in service in the qualified opportunity zone. If the tangible property had been so used or placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved to satisfy the requirements of section 1400Z-2(d)(2)(D)(i)(II).” Prop. Reg. § 1.1400Z2(d)-1(c)(7).
The Promise of Opportunity Zones for Franchise Businesses

<table>
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<td>Current or prospective franchisors. (Non-institutional.)</td>
<td>Few, if any—only those franchisors with a mandate to invest equity in franchise locations managed by franchisees.</td>
<td>Some. Franchisors that own locations will be able to enjoy the opportunity zone incentives. They can also seed new innovative products inside QOZ entities and consider opportunities for their own corporate restructuring. Finally, by educating current and prospective franchisees and tailoring their franchise systems to accommodate opportunity zone laws, franchisors can help franchisees enjoy QOZ tax benefits as they grow.</td>
</tr>
<tr>
<td>Real estate developers and private equity funds.</td>
<td>Relatively few. Developers and private equity funds will focus on projects they can control and to which they can add significant value.</td>
<td>Yes. Their value-add focus and familiarity with complex legal structures make it likely that they will be the leading QOF operators, investing in a diverse set of businesses, including franchises.</td>
</tr>
</tbody>
</table>

1. Depending on fund structures, accredited investor standards might also preclude franchise businesspeople from participating in Qualified Opportunity Fund investments as limited partners.

A. Current or Prospective Franchisees

Because the opportunity zone laws require investors to have capital gains57 to access the tax benefits, countless investors without capital gains will not be able to participate until they have gains.58 This may be relevant for franchisees without capital gains of their own that want to build businesses in QOZs and raise capital using a QOF. These franchisees may succeed in doing so, and their investors will reap the tax benefits, but they themselves will not obtain the benefits for their own capital. New regulations clarify that a profits interest earned by such fund sponsors will not be treated as tax-advantaged under the opportunity zone laws.59

Even those franchisees with capital gains may be reluctant to invest in opportunity funds as passive investors because of the risk profile of the

59. The profits interest of the operating partner will be treated as an interest derived from a contribution of non-qualifying capital and thus subject to the mixed-funds investment rules of I.R.C. § 1400Z-2(e)(1).
value-add investment, the ten-year hold requirement, and the phantom tax burden in 2026. Furthermore, unless they are accredited investors, many limited partnership investment opportunities may be closed to them. Active investors, however, will have great opportunities to grow their business in QOZs. As illustrated in the examples above, there are tax-advantaged ways to bring new businesses into QOZs or expand\(^60\) a franchisee’s current model into QOZs. Area developers will be well-positioned to orient their new or existing plans to seed more business in QOZs, especially when a change in location or strategy will not materially impact the forecasted performance of the new locations. Franchisees will need good legal counsel, however, because the compliance requirements will necessitate up-front planning and structuring that will likely be unfamiliar to most small-scale franchisees. For example, many franchisees may expect to form their investment entities as single-member LLCs that are disregarded entities for federal income tax purposes, but this structure does not comply with opportunity zone law.\(^{61}\)

B. Current or Prospective Franchisors

Even among franchisors with a mandate to invest equity in franchisee locations, only those franchisors with capital gains will be able to directly access the opportunity zone tax benefits. Similarly, franchisors with corporate-owned locations will miss out on the QOZ tax benefits without capital gains to utilize. However, franchisors can help franchisees cultivate successful businesses in QOZs by providing education and support, and also by making sure that the franchise agreements and business systems accommodate the QOZ requirements. Successful and satisfied franchisees will contribute to a stronger and more successful franchise.

Franchisors with capital gains will have several ways to benefit from QOZs. Franchisors with a mandate to invest equity in franchisees or open (or move) company-owned locations can benefit directly by investing in new locations. But all franchisors can consider ways to improve their internal corporate tax position using subsidiaries located in QOZs. For example, a franchisor in the fast-food industry interested in developing a patent for a new type of ice cream might consider developing that product within an opportunity fund structure. Specifically, the company might open a corporation treated as an opportunity fund for federal income tax purposes and fund it with cash that corresponds to gains the parent company realized within

\(^{60}\) Those franchisees that their owned businesses in QOZs before the new laws were passed will not benefit unless they grow their business or portfolio through a new entity. Because QOZ investments must be made at arm’s length (see I.R.C. § 1400Z-2(d)(2)(D)), those investors who already own businesses in QOZs will not receive the tax benefits for investing in those properties and will not have any special incentive to upgrade their businesses (i.e., they may not sell their business to their own opportunity fund in order to attempt to obtain the tax benefits).

\(^{61}\) I.R.C. § 1400Z-2(d)(1) requires that a QOF must be “organized as a corporation or a partnership.” However, the proposed regulations clarify that a QOF may be organized as an LLC as long as it elects to be treated as a corporation or partnership for federal income tax purposes.
the previous 180 days. The opportunity fund could then serve as the business developer or open a wholly owned subsidiary to serve as the owner of the business being developed. If the business becomes successful over a period of time, the parent corporation could, after ten years, sell its interest—in whole or in part—in the opportunity fund and get a basis step-up and avoid capital gains taxes on the value appreciation.62

C. Real Estate Developers and Private Equity Funds

Real estate developers and private equity funds are the investors most familiar with the business models, people, and legal structures involved in value-add investing. As a result, they are the best-positioned members of the franchise industry to benefit from the new QOZ laws. Fund structures may change slightly, and holding periods might be longer than usual, but QOZ investing will look almost identical to the work developers and private equity funds have been doing for decades. Investors eager to parlay their capital gains into QOZ businesses and buildings may offer their funds to private equity firms at a relatively low cost of capital—something that will further incentivize private equity involvement.

Fund operators may also adjust the strategies of some of the companies they currently own to take advantage of the QOZ benefits. For example, a private equity firm purchasing a national franchise might master a process for moving or growing the business or parts of the business into nearby QOZs to take advantage of the tax benefits.63 Because this strategy could make a meaningful impact on investor returns, some commentators are predicting a substantial migration by private equity-funded companies to QOZs near core business centers. For example, companies buying or building high-potential companies in the Silicon Valley area could opt out of expensive San Francisco and instead focus on cheap, QOZ-filled Oakland only ten miles away. Such companies would still enjoy the Silicon Valley region’s resources, while benefiting from the relatively inexpensive Oakland real estate and the

62. Amazon, for example, was attracted to this possibility in New York’s Long Island City, the once-planned site of a new headquarters, announced in 2018 and cancelled in 2019 for reasons unrelated to opportunity zones. Amazon’s planned footprint included locations within QOZs, presenting opportunities for creative tax avoidance. Amazon, one of the world’s most valuable companies, has many lines of business that have each generated exponential growth on their own, including Amazon.com, Amazon Web Services, and its Alexa devices. Under the QOZ laws, Amazon can start its hundreds or thousands of new research and development initiatives within QOZs, each seeded with some of its capital gains funds and all owned inside an opportunity fund structure. Over the long term, any successful initiative can be sold or offered to the equity markets through an IPO and avoid all capital gains on the investment. Since the project has now been cancelled, Amazon will need to focus on other QOZ locations if it wants to enjoy the law’s tax benefits. As mentioned above, companies with outsized amounts of intellectual capital, whether in the form of patents or highly productive engineers, entrepreneurs, and scientists, will probably be the biggest beneficiaries of the QOZ laws.

63. Investment company Garnett Station Partners, for example, purchases franchises and other operating businesses across the United States (many of which happen to be in QOZs). The company improves its tax position by growing its in-place model through QOZ structures. GSP Opportunity Fund, http://www.garnettstation.com/opportunity-zones/ (last visited June 4, 2019).
tax benefits that come from growing in a QOZ. Those franchise businesses that do not have to locate their operations on particular block or neighborhood (e.g., the headquarters for a landscaping or online-based company) can utilize the same strategy and locate their headquarters in a QOZ.

As described above, private equity and real estate development firms are best-positioned to lead the franchise investment efforts in QOZs across the United States. But the smaller franchisees that constitute a major portion of American economic activity also have substantial experience to bring to the table, whether they have capital gains or not. For tax and lifestyle purposes, these operators usually think about their ownership over decades-long time spans, a perfect match with the opportunity zone law requirements. Additionally, these operators may have experience in lower-income communities that private equity and real estate development firms generally try to avoid. Low household earnings, high unemployment, low educational attainment, and other location-specific realities may discourage institutional parties but might not be an obstacle to long-term community members who are more familiar with the opportunities and challenges of the area. Because of the challenges of structuring opportunity fund investments in a way that meets the governance, cash flow, and simplicity needs of smaller franchisees, many of them will miss out on this opportunity, even those in growth-mode with capital gains available.

IV. Increasing Franchise Activity in Opportunity Zones

Many franchise industry insiders can play a role in expanding franchise business activity in QOZs. They can do so by increasing the availability of capital and expertise to franchisors and franchisees interested in enjoying opportunity zone tax benefits.

A. Trade Groups

Franchise business trade groups and owners associations can educate industry leaders by sharing model documents relating to opportunity fund structuring and disseminating case studies of franchisees that successfully invested through opportunity funds. Because every franchisee and every QOZ will likely have unique strengths and characteristics, a diversity of case studies must be shared. Case studies might include (1) a first time or repeat franchisee that opened a new location in a QOZ; (2) a franchisee that purchased a business and moved it into a QOZ; (3) a franchise that purchased a franchise in a QOZ and substantially improved the business to make the investment qualify under the law; (4) a franchisor that structured a franchise offering to make it easy for franchisees to build tax-advantaged businesses within QOZs; or (5) a franchisor that supported franchisee efforts to purchase businesses and convert them over to the franchise system while moving their central activities to a QOZ.
B. Law Firms

Many law firms supporting franchise businesses have little experience dealing with QOZ law because very few clients have had matters relating to Code Section 1400Z-2. As a result, most law firms are likely underprepared to walk clients through their specific options in this area. This situation offers law firms a great opportunity to get ahead and offer a turnkey service to learn about the client’s goals and explain the opportunity zone strategies available to them. Billing clients for research time may be a challenge here given the fact that relatively simple entity-structuring projects may take firms a long time to complete given the initial research necessary.

C. Limited Partners

Franchise investors, whether industry veterans or not, can provide capital but also expertise to franchisees interested in expanding into QOZs. Franchisees with and without capital gains may be interested in QOZ projects but may lack the legal and strategic guidance to understand how the project will differ from non-QOZ projects.

D. Franchisors

As discussed above, franchisors with offerings that are well-suited to QOZ locations can distinguish their brands and increase franchisee satisfaction by helping franchisees buy or grow in QOZs. One way might be to provide basic guidance relating to structuring franchisee entities. Model documents could also be helpful, demonstrating to franchisees how to structure a deal that qualifies for the tax incentives. These documents could include (1) partnership agreements or shareholder agreements between equal partners or between operating partners and passive investors; (2) written investment plans or improvement schedules for the “substantial improvement” requirements under the law; and (3) detailed case studies that include sample agreements among deal principals, sample tax forms related to the investment, and sample business plans. These documents can assuage some of the fears current or prospective franchisees may have about opening a location in a QOZ—especially a location that they may not have opened but for the new tax benefits.

Large developers and private equity firms have the legal budgets and experience to execute opportunity zone deals with ease. But small-scale franchisees and franchise investors could also make a major contribution to the opportunity zone investment landscape. Because many of them are already inside or very close to QOZs, they may see opportunities to start a new venture or expand their own business within a few blocks of their current offices. These investors may also be experienced and interested in types of

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64. See I.R.C. § 1400Z-2(d)(2)(D)(ii). To qualify for opportunity zone benefits, an investment must be “substantially improved.” This is consistent with the law’s purpose of bringing new capital into areas with challenging economic conditions.
businesses that the larger private equity and developers usually skip. But these are the investors most likely to opt out, in part because of their lack of fluency with contracts and legal structures that are more complex than those they regularly use. As discussed above, financial requirements also exist that many franchisees might not be able to meet, such as the phantom tax burden and the ten-year hold. Finally, many franchisees might not have capital gains available, a prerequisite for enjoying the tax benefits.

V. Conclusion

The opportunity zone laws offer great promise to investors large and small because of their lack of an expenditure cap and the ability for investors to self-certify as an opportunity fund. But the opportunities available to investors will vary greatly depending on that investor’s experience, capital gains availability, and risk tolerance. While private equity firms with years of experience dealing with value-add investments and complex legal structures may succeed in acquiring hundreds of franchise locations and moving them into QOZs to qualify for tax incentives, smaller franchisees—especially those without capital gains—may not have many options for accessing the benefits of the new laws. Franchisors, their advisors, and limited partners can all tap into the benefits by educating operating partners about opportunities and creating turnkey solutions to connect successful operators with the kind of capital and legal structures they need to benefit from the new opportunity zone law. By parsing the types of franchise business operators and investors in the market, industry leaders can better prepare advice and products tailored to each participant’s needs.