PERSONAL GOODWILL FOR NEW QO FUNDS, BUSINESS GOODWILL FOR OLD ONES: IRS MAY CRY "WHIPSAW"

—Andrew Gradman

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To maximize the tax benefits of Qualified Opportunity Funds, some investors are shunning real estate and chasing service-oriented businesses. As Ira Weinstein and Steve Glickman explain in The Guide to Making Opportunity Zones Work: "During the 10-year investment horizon for an OZ holding, a good return on a real estate investment might be tripling or quadrupling your money. In the business space, investors are typically looking for returns up to 10 times their original investment and beyond."

This makes good sense. In any QO Fund, the goal is to maximize built-in gain on the exit date. This is done by maximizing the sum of economic appreciation and tax depreciation, and avoiding taxable sales. While rental real estate happens to check all these boxes, a successful services-based business might do even better. The only difference is that the appreciated asset consists of intangibles (mostly business goodwill) rather than tangible property.

Problems arise, however, when the "new" business isn't really "new"—that is, when the taxpayer tries to transplant an existing business into a QO Zone. The problem here may not be obvious. Is this a violation of the related-party rules? No, there is no such prohibition for intangibles. Will the intangibles fail the requirement that a "substantial portion" (40%) of intellectual property be used in the active conduct of a trade or business in the QO Zone? Not necessarily; the final regulations take an extremely liberal position on what it means to meet that test. See TD 9889 at 85 FR 1920 ("First, the use of the intangible property must be normal, usual, or customary in the conduct of the trade or business. In addition, the intangible property must be used in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business.")

However, consider this: At Year Ten, to maximize gain forgiveness, we will want to argue that any goodwill belongs to the business, and not to its owner. If so, then the same was probably true at Year One. Customer lists, customer relationships, trade secrets—the IRS will take the position that these appeared on the initial balance sheet. And how did they get there? The investor either sold these to the Fund for previously invested cash or contributed them for membership interests.

Either way, that's a problem. A sale would be disregarded as a "circular cash flow." See TD 9889 at 85 FR 1871 ("the circular movement of the consideration in [a similar] transaction would be disregarded [and] the transaction would be treated for Federal income tax purposes as a transfer of property to the purchasing QOF for an interest therein . . ."). And because the contributed intangibles have a low basis, they would not give rise to a "qualifying investment." See TR 1.1400Z2(a)-1(c)(6)(II)(B). Instead, these low-basis intangibles would create a "mixed investment," diluting the gain forgiveness at Year Ten in the same proportion as the value of the contributed intangibles bears to total contributions.

To avoid this disaster, service-based QO Funds should get an appraisal showing the opposite—i.e., that any initial goodwill is, in fact, personal to its investors. However, having done so, they should anticipate a headache of their own creation: Ten years later, when the business tries to claim the goodwill for itself, the IRS will claim it is being whipsawed. The planner will need to have a plausible response.