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STORIES INSIDE

Can You Get a Brew in an OZ? Opportunity Zones, Brew Pubs and Sin Businesses

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One of the advantages of the opportunity zones (OZ) incentive is that there are few restrictions on the type of business that can be invested into. Real estate investments, technology companies, service companies and many other businesses are possible. However, Congress did choose to prohibit qualified OZ businesses from investing in what are commonly called "sin businesses."

By cross-referencing Internal Revenue Code (IRC) Section 144(c)(6)(B), Congress prohibited the following: "private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises." This article looks at the question of whether a real estate project that includes a brew pub can be structured to avoid the sin business prohibition.

An important starting point is that the sin business prohibition applies to qualified OZ businesses but not qualified opportunity funds (QOFs). Investors generate OZ benefits by investing in QOFs, which commonly invest in qualified OZ businesses to meet various OZ requirements. However, it is possible for a QOF to choose to directly own property and run its own business rather than invest in a qualified OZ business. In what appears to be a drafting hole by Congress, the statute does not prohibit a QOF from running a sin business, it only prohibits a qualified OZ business from engaging in a sin business. Thus, a QOF could own and run a golf course or a liquor store, but a qualified OZ business generally could not.

Commentators noted this discrepancy and asked the IRS if it would use its regulatory power to prohibit QOFs from doing things that qualified OZ businesses could not. Treasury Regulation (Treas. Reg.) Section 1.1400Z2(d)-1 issued Jan. 13, 2020, by the IRS definitively answered the question and confirmed that the sin business rule does not apply to QOFs that directly run a business. (See Treas. Reg. Section 1400Z2(d)-(1)(d)(4)(iv)(C), Example 3 [golf course run by a QOF is not prohibited]). However, because qualified OZ businesses are generally afforded more flexibility in complying with OZ requirements, most QOFs choose to invest in partnerships or corporations that are qualified OZ businesses rather than own property and run their own business. For example, the 31-month working capital safe harbor in Treas. Reg. Section 1.1400Z2(d)-1(d)(3)(v) applies to nonqualified financial property restrictions, which are only applicable to qualified OZ businesses but does not help QOFs comply with their own OZ property requirements. As a result, while it is conceivable to run a sin business in a QOF, it is very unlikely in practice.

The sin business prohibition is part of the basic definition of a qualified OZ business. IRC Section 1400Z-2(d)(3) defines the requirements to be a qualified OZ business, including that the trade or business is not among the excluded businesses described in IRC Section 144(c)(6)(B).

The excluded business that this article focuses on is the prohibition on a trade or business which is "any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

The obvious target of the prohibition against stores selling alcohol for off-site consumption is retail liquor stores. They are clearly not allowed. Breweries that produce alcohol and solely engage in retail sales to customers who will consume the alcohol off-site also should be prohibited. Conversely, it is commonly accepted that restaurants that happen to serve alcohol for on-site consumption are permitted. Bars that sell alcohol for on-site consumption should also be allowed. In addition, wholesalers that do not sell to the public but who only sell to retailers should similarly not be considered a prohibited sin business, based on Private Letter Ruling 8743008 (July 22, 1987), which interpreted similar language in Section 147 and concluded that the prohibition on stores with a principal business of selling alcoholic beverages for offsite consumption only applies to retail facilities and does not apply to a wholesale warehouse.

The more difficult situation is brew pubs. Brew pubs are commonly hybrids between restaurants and breweries. They brew their own beer and typically sell at least 25% or more of their beer on-site and usually have significant food services, according to the Brewers Association. Does a brew pub fall into the disallowed sin business category? Is the analysis different for qualified OZ businesses whose trade or business is the operation of a brew pub as compared to a qualified OZ business that owns a building and leases it to tenants, one of which might be a brew pub? Below are some possible ways to analyze the issue.

Step 1: Principal Business Analysis

Is the sale of alcohol for off-site consumption the principal business? What "principal" means in this context is not crystal clear. Clearly, if off-site alcohol sales are more than 50%, such sales would be the principal business. But what if sales for off-site consumption are 40% of sales, on-site food and alcohol sales are 30% and sales of alcohol to retailers for resale are 30%? Now sales for off-site consumption are not a majority but are a plurality and may be considered the principal business. If, however, alcohol sales for off-site consumption are not the largest segment of the business, then they should not be considered the principal business. In arriving at that conclusion, it is noteworthy that the definition of sin business says "the principal business" rather than "a principal business" because this seems to indicate there is only one principal business. Prospective qualified OZ businesses whose trade or business is the operation of a brew pub should establish that the sale of alcohol for off-site consumption is not the leading business.

An interesting question arises during the COVID-19 pandemic. Assume that sales for off-site consumption of the brew pub previously were not the leading sale items (or for a new business were not expected to be the leading sales item). However, during the pandemic the dining room was closed and on-site consumption of food and alcohol was prohibited, with the result that now the majority of sales are retail sales for off-site consumption. In that case, a brew pub that was not expected to have a principal business of selling alcoholic beverages for sale for off-site consumption might unexpectedly end up a sin business. Given the national disaster situation, it would seem like a solid argument could be presented to the IRS that the principal business should be evaluated outside of the pandemic situation. Thus, if facts could be established that but for the disaster the principal business would not have been the sale of alcoholic beverages for off-site consumption, then perhaps the IRS could be persuaded that the brew pub should not be considered a sin business.

The sin business prohibition can also arise if a qualified OZ business landlord leases space to a brew pub. As described above, the sin business issue can be avoided if the principal business of the brew pub tenant is not the sale of alcohol for off-site consumption. Alternatively, the landlord entity can rely on two "de minimis" approaches afforded by the regulations, described below.

Step 2: De Minimis Property Analysis

Treas. Reg. Section 1400Z-2(d)-1(d)(4)(i) provides that if a partnership or corporation that owns real estate leases a portion of that to a sin business, then such entity is only disqualified as a qualified OZ business if more than a de minimis amount of property is leased to the sin business. A de minimis amount of property is less than 5% of the net rentable square footage for real property and less than 5% of the value of other tangible property according to Treas. Reg. 1400Z2(d)-1(d)(4)(iii). Thus, if the space leased by a potential qualified OZ business to a brew pub is less than 5% of the net rentable square footage owned by the entity, then the brew pub will not disqualify the entity from qualifying as a qualified OZ business and being entitled to OZ benefits.

Applying this analysis to a brew pub, if the brew pub is less than 5% of the net rentable square feet of the lessor's real estate, then the lessor should not be disqualified from being a qualified OZ business. Notably, the regulation does not seem to look on a per-building basis and an entity with multiple buildings arguably could use the aggregate net rentable square footage of all of its real estate and compare that to the space occupied by a brew pub in just one building.

Step 3: De Minimis Sales Analysis

The regulations provide a second de minimis exception where de minimis amounts of gross income attributable to a sin business will not cause the trade or business to fail to be a qualified OZ business (Treas. Reg. Section 1400Z2(d)-1(d)(4)(ii)). A de minimis amount of gross income is less than 5% of the gross income of the entity, according to Treas. Reg. Section 1400Z2(d)-1(d)(4)(iii).

Let's assume the brew pub is more than 5% of the lessor's net rentable square footage and it is uncertain if the principal business of the brew pub will be the sale of alcohol for off-site consumption. If the lessor can show that less than 5% of the qualified OZ business's gross income comes from rent from the brew pub, then the de minimis sales exception should apply so that the lessor can qualify as a qualified OZ business.

Regulation Example

Example 1 in Treas. Reg. Section 1400Z2(d)-1(d)(4)(iv)(A) provides a helpful example, although not specifically regarding the sales of alcohol for off-site consumption. In the example a corporation operates a hotel. As part of that trade or business, the hotel operates a spa which provides massage and other therapies. As noted above, massage parlors are a sin business. The facts of the example say that the hotel's income from the spa is less than 5% of gross income and that floorspace is less than 5% of net rentable floorspace (see the discussion about floorspace below). The example concludes that the operation of the spa does not prevent the corporation from being a qualified OZ business.

The regulation is helpful in that it applies the de minimis rules to a hotel business included a spa as part of that business. Therefore, the regulation clarifies that the de minims approaches can be used both by entities running trades or business that include a potential sin business as well as entities that lease space to such businesses.

From a different angle, the example does not provide as much details as one would like. What if the spa sales were 6% of the hotel gross sales, but only half of that 6% was from massages and the rest was from yoga classes and other non-massage therapies? What if the square footage was 6% but only half of that was for the massage rooms and the rest was for health club facilities? The example refers to the trade or business of running a hotel and that the operation of the spa was part of that trade or business. One could argue that if the massage sales and massage space was determinable (perhaps distinct by management, financing and accounting), then perhaps one could look to just those items.

In the brew pub context, the relevant questions would be how much space does the sale of alcohol for off-site consumption take up and how much sales (and a corresponding amount of gross rent to the qualified OZ business) would be deemed to be from prohibited alcohol sales? Unfortunately, the example does not go into sufficient detail to answer these question definitively and therefore under the current regulations it is prudent to include all of the brew pub space and not just a subset of space used for off-site sales or just off-site sale amounts. However as discussed above, in the brewpub area as long as the sales for off-site consumption are not the leading source of sales, then one should be OK. So in this alternative example, if alcohol beverage sales for off-site consumption were 6% of sales, one doesn't need to look to the de minimis rules as long as there is some other function which has a higher amount of sales and would be the "principal business" of the tenant.

Conclusion

Brew pubs where sales of alcoholic beverages for off-site consumption are not the leading form of sales should not be considered a sin business whether the qualified OZ business operates the brew pub itself or leases space to the brew pub. Brew pubs where such sales are the leading form of sales may still be OK if the rent a qualified OZ business landlord receives from the brew pub is less than 5% of the landlord's gross revenue or if the brew pub takes up less than 5% of the net rentable square footage of the qualified OZ business. ❖

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