

**To:** Secretary Dennis Davin, DCED  
Deputy Secretary Carol L. Kilko, DCED

**From:** NAIOP Pittsburgh & NAIOP Philadelphia

**Subject:** KOZ Proposed Guideline Changes

**Date:** 09/30/2020

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### **Executive Summary**

The Department of Community and Economic Development proposed changes to its guidelines interpreting and administering the state's Keystone Opportunity Zone (KOZ) program contains language that either would have unintended consequences or are contrary to the KOZ Act and will adversely affect real estate owners and other companies within a KOZ. The Commonwealth is combatting unprecedented recessionary times resulting in historical levels of unemployment. Amidst this economic reality, real estate development, as a generator of professional, skilled and unskilled jobs, should be encouraged not hindered. Additionally, real estate companies provide the physical requirements for other companies (their tenants) to locate in KOZs. A negative impact on real estate companies will have the unintended consequence of discouraging many other firms from being in a KOZ who wish to rent their operational presence versus own it.

NAIOP of Pittsburgh and Philadelphia, whose members include real estate developers, architects, engineers, brokers, construction companies, investors, lenders, and other consultants have several concerns and recommendations related to the DCED's newly suggested changes to the criteria it will review in determining if an applicant is a "qualified business" for purposes of obtaining certain KOZ benefits under the KOZ Act.

### **Proposed Guideline Changes & Concerns**

The Department added to its description of a "qualified business" in the KOZ Program Guidelines (dated July 2020), the following:

- The "active conduct of a trade or business" means a business: (1) engaged in a commercial enterprise conducted for profit earning "net profits" as that term is defined in Section 303(a)(2) of the Pennsylvania Tax Reform Code of 1971, from the operation of the business within the Subzone; and (2) employing at least one full-time employee within the Subzone. Activity from real estate investment trusts, venture capital funds and hedge funds are not engaged in the active conduct of trade or business for the business.

We have several concerns with this description of a "qualified business."

- The proposed guidelines state that to be a *qualified business*, a business must produce *net profits* within the meaning of the Personal Income Tax (PIT) statute which is contrary to the KOZ Act. Section 820.512(a.2) of the KOZ Act specifically provides that not only net profits, but also net rents and net gains from activity within a KOZ, are exempt from PIT for a pass-through entity and its owners. The inclusion of net rents as exempt in the hands of the real estate owners is important, as many real estate entities characterize their income as net rents, and therefore the new guidelines would preclude real estate owners from participating in the intended benefits of

the KOZ Act. In addition, this change disregards that many applicants for KOZ benefits, are not subject to PIT, such as corporations, and thus would not have their income categorized under the PIT classes of income.

- The proposed guidelines state that to be a *qualified business*, a business must have at least one full-time employee in the KOZ. There is no such requirement in the KOZ Act, and we believe that one should not be added and recommend that any such requirement be removed. However, if the DCED intends to include such a requirement in its KOZ Guidelines, then additional clarification is required and there should be flexibility provided as to how an applicant can meet such a requirement due to the realities of the way businesses are operated due to the following:
  - Most real estate companies take title to property via so-called “Single-Purposes Entities” (whether located in a KOZ or not). This practice is customary for limitation of liability purposes and is often a prerequisite to obtain financing for a project. Typically, Single-Purpose Entities will not directly employ any individuals; rather, the parent organization serves as the employer. The single-purpose entity structure is but one commonly used organizational structure that results in an affiliate, rather than the owner of a property, employing individuals who perform work at or related to the property. In any event, Real estate owners qualify for KOZ benefits by way of their capital investment in the KOZ and not necessarily their operations within a KOZ.
  - Additionally, businesses commonly use organizational structures which require various pass-through operational entities (which often do not have employees) and an affiliate (which does have employees) providing the needed services to these entities. The purpose of this arrangement is to segregate the investment risk from any possible employee-related risks. These organizational structures, and the lack of employees within each entity within the structure, should not disqualify each of the companies located within the KOZ from receiving approval for KOZ benefits.
- The proposed changes to the KOZ Guidelines include a wholesale exclusion of real estate investment trusts, venture capital funds and hedge funds. The proposed KOZ Guidelines offer no premise for the blanket assertion that such entities are not actively conducting business, nor is any such exclusion supported by the KOZ Act. Real Estate Investment Trusts, for example, are simply a mechanism for real estate companies, on the one hand, to access public capital markets and investors, on the other hand, to invest in portfolios of real estate assets the same way they invest in other industries. Likewise, hedge funds and venture capital funds are actively conducting business, whether it be the management of money or the deployment of capital.

### **Conclusion & Recommendations**

NAIOP Pittsburgh & NAIOP Philadelphia believe that the proposed changes to the KOZ guidelines are contrary to the statute (or the intent thereof) and will adversely affect real estate owners. We respectfully ask that DCED consider the following changes to the proposed guidelines:

- A clarification stating that Real Estate Owners/Developers are Qualified Businesses related to their investment and business activities in a KOZ. This would keep the direct impact on Real Estate companies to a minimum (and not hinder development in KOZs) and would solve:
  - Not qualifying due to Net Rents (vs Net Profits)
  - Not qualifying due to SPE ownership without employees located in the KOZ
- Removal of the requirement that a qualified business have at least one (1) full-time employee in the KOZ. Alternatively, add language that a company itself, or its affiliates (may need some further definition around this), could meet the requirement to have an employee located in the KOZ. This would solve the following:

- Not allowing shell companies to locate in the zone and take advantage of the KOZ benefits
- Allowing companies which are legally structured with numerous affiliates and/or contract employees located in the zone to still take advantage of the KOZ benefits
- If a company has previously applied for and received approval for KOZ benefits, it should not be declined approval in a future year due to changes in the KOA Act or KOZ Guidelines, so long as it continues to meet the requirements of the current KOZ Act – namely timely filing of annual applications and tax compliance certification. This would solve:
  - Any confusion on the part of the applicant that those benefits will not be revoked in the middle of their KOZ contract with the Commonwealth.
  - It will provide all companies which have, or will invest, in a KOZ based on the expectation of benefits comfort that future changes to the legislation cannot revoke their benefits.