THE STATE OF OPPORTUNITY ZONE INVESTING

PROFESSIONALS

Blake E. Christian

A POWERFUL FEDERAL PROGRAM REQUIRES CAREFUL STATE ANALYSIS

December 19, 2018

Blake Christian, Tax Partner and Edvin Givargis, Tax Senior Manager

For Further Information
Blake Christian
T: 435.200.9262
F: 435.200.9277
BlakeC@hcvt.com

The Federal Opportunity Zone Program – Overview

The 2017 Tax Cut and Jobs Act (2017 Act) created the federal Qualified Opportunity Zone program (QOZ or Program) which became effective in 2018 and will be operative for up to the next three decades.

Effective January 1, 2018, through December 31, 2026, individuals, C and S Corporations, REIT's, partnerships and other pass-through entities can sell their appreciated capital assets and elect to reinvest the resulting capital gain income into a Qualified Opportunity Funds (QOF). The federal tax impact of participating in a QOF includes deferring qualified gains for up to eight years and permanently exempting up to 15% of the original federal gain and 100% of the ***post-reinvestment gain*** – after holding the investment for seven and ten years, respectively. California has indicated they will not be conforming to the federal rules and investors must carefully evaluate the state impact of any reinvestment.

The Program offers very flexible tax savings and diversification tool for taxpayers generating larger gains. To participate in the Program, the taxpayer must roll all or a portion of their short-term or long-term capital gain into a QOF. The QOF must then timely invest the deferred gains into undeveloped or developed real estate, a new or existing QOZ-based business, or directly into other qualified QOZ property.

Even though all states have QOZ census tracts, that only impacts the federal tax benefits, states can elect to have the QOZ provisions apply for state purposes – or not. To date, only 28 states and the District of Columbia[1] have opted in, although more states may conform in the near future.

Opportunity Zone State Issues

While the federal Program offers tremendous tax planning opportunities for taxpayers, the state ramifications can be a minefield for the uninformed – especially with a new and complex program such as the QOZ.

THE STATE OF OPPORTUNITY ZONE INVESTING

When choosing an investment within 8,700 census tracts (plus U.S. Territories) and various specific QOF(s), care must be taken from a state tax planning perspective.

As reflected above, only about half the states have fully embraced the Program; therefore, taxpayers may still incur the full brunt of taxation in their home state – and may also generate tax liabilities in other states (nonresident or non-commercial domicile states) if the QOF makes investments in real estate or businesses in other jurisdictions.

Opportunity Zone Treatment in Your State of Domicile or Residence

For example, assume in Utah (a conforming state), a resident invests their $1,000,000 gain from the sale of a Utah asset into a QOF that then invests in a California real estate project. Further, assume that the QOF subsequently appreciates to $1,700,000 in year ten and the investor liquidates their QOF investment.

Since Utah currently recognizes the QOZ Program, the original $1,000,000 gain will be deferred for both federal and Utah purpose and the taxpayer will start with a $0 tax basis in the QOF. As a result, there will be a 10%, 5%, and 100% basis "step-up" at years five, seven, and ten for both federal and Utah purposes. In the year 2026, $850,000 of the original deferred gain will be reportable, and the federal and state tax basis will then be $1,000,000 in the QOF from December 31, 2026, through the ten-year holding period in the year 2028, at which time the basis will be adjusted to fair market value.

Since California does not recognize the QOZ Program, the taxpayer will start with a $1,000,000 tax basis in the QOF, and no basis adjustment will occur at the five, seven and ten-year milestones. When the QOF is ultimately sold, the $700,000 gain ($1,700,000 less $1,000,000 California tax basis) will be fully reportable in California, and the Utah taxpayer will pay California tax on the full net gain in the year the investment in the QOF is sold. Since there is no Utah tax imposed on the gain, there is no offsetting state tax credit available.

Therefore, taxpayers living in higher taxed states that have not adopted the QOZ Program should evaluate entering into an IRC Section 1031 "Like-Kind Exchange" transaction instead of a QOF if the asset being disposed of is real estate (with consideration given to whether the state has an IRC Section 1031 "claw-back" provision such as California). Note that due to the 2017 Tax Act, post-2017, IRC Section 1031 transactions are now limited to real estate assets, not personal assets such as cars, art, and other personal assets which were eligible prior to the 2017 Act. The QOZ Program, however, is available to defer gain on any asset that generates short-term or long-term capital gains.

Taxpayers' Treatment in States That Have Adopted the Opportunity Zone Program

If an investing individual, estate, trust, or business entity is a resident of, or is commercially domiciled in, a state that has adopted the federal Program (as enumerated in footnote 1.), it will be advisable for them to limit their QOZ investments to their home state or one of the other states that have fully adopted the Program. In such cases, the original deferred gain will not be recognized until the earlier of December 31, 2026, or the date of sale of their QOF investment. The statutory tax basis step-ups in years five, seven and ten will be available to the investor for ***both*** federal and state purposes.

Opportunity Zone Investing Outside the Investor's State of Residence

A California resident with an interest in investing in **Alaska, Nevada, Texas, South Dakota, Tennessee, New Hampshire, Washington, Wyoming or Florida** (states that do not impose an individual income tax) that makes an investment in a QOF or directly into a QOZ business (or a piece of real estate in one of these states) may be surprised that California will still whittle away at their ROI as a result of taxing the gain.

Even though the investor will not incur state-level individual income tax in these nine nonresident states, California and most other states that impose a personal income tax have a long reach and will still tax the original gain and the post-reinvestment appreciation associated with the QOZ investment.

The multi-state taxation exposure gets more complicated as you expand the fact pattern to consider investment in a state that imposes an income tax. In such cases, where the nonresident state imposes a tax on the sale, **the investor must evaluate the future net tax exposure BEFORE making a QOZ investment.**

For example, if a Utah taxpayer with the same $1,000,000 California-sourced gain disposes of the investment and finds an attractive investment in Hawaii, a non-conforming state, which has a maximum marginal individual income tax rate of 11%, then the original $1,000,000 deferred gain should not be taxed in Hawaii since the original gain was not sourced to that state. Likewise, for state purposes, the taxpayer will start with a $1,000,000 Hawaii basis in the QOF investment ($0 tax basis for federal) and the Hawaii tax basis in the investment will **not be stepped-up in years five, seven or ten for state purposes**, since they have not conformed to the Program.

When the Hawaii related QOF is ultimately sold, the difference in the net proceeds from the sale – assuming $1,700,000 - and the $1,000,000 original investment (adjusted for appropriate partnership or corporate activities), that $700,000 post-investment gain will generally be exempt for federal and Utah but reportable in Hawaii, unless the investment being sold is stock of a C Corporation, S Corporation, or a Real Estate Investment Trust (REIT). The reason for the potential exclusion in the nonresident state is that stock is considered an intangible asset and such gains are generally sourced to the taxpayer's state of residence or commercial domicile in the case of a business entity – Utah in this case. However, a commonly used IRC Section 338(h)(10) election for an S Corp sale (338(g) for C Corps) – deemed asset sale – the election will still generally trigger state-level tax in Hawaii – the location of the real estate.

If the taxpayer is selling a partnership interest, (which is treated as selling the underlying assets colloquially referred to as the "look-through rule") or other tangible assets, then Hawaii and most other states will tax the portion of the gain derived from the sale of property within their borders. Neither Utah nor the IRS will tax the $700,000 post-reinvestment gain since the investment was made under the Program. Since there is no double-tax at the state level, there is no Utah credit generated and the Utah resident will end up paying a Hawaii state rate as high as 11%, rather than the "normal" 5% Utah tax rate. As a result, the fact that the investor chose a high-tax, non-conforming Program state caused them to more than double their state tax.

The combination of varying state tax rates, credit provisions, and varying conformity measures with respect to the QOZ lends to a far more complicated state tax investment landscape, and as such, taxpayers contemplating a QEF investment will be well served to consider all possible scenarios fully in order to understand the exit scenarios and their impact on their investment goals and strategies.

THE STATE OF OPPORTUNITY ZONE INVESTING

Blake is a tax partner in the Long Beach and Park City offices and Edvin is a senior manager in the Long Beach office of HCVT – a Top 30 CPA firm in the U.S. with 12 offices in California, Arizona, Utah, and Texas. For more information, they can be reached at (562) 590-9535 or blakec@hcvt.com and edvin.givargis@hcvt.com

[1] OZ Conforming States - Alabama, Colorado, Connecticut, Delaware, District of Columbia, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Virginia, West Virginia, and Wisconsin.
The following states do not have reciprocity with California for the state tax credit: Alaska, Arizona, Connecticut, Florida, Nevada, Oregon, South Dakota, Texas, Washington, and Wyoming.
California tax rate on $700,000 of income assuming "married filing joint" status.
Income of $700,000 will force a Maine resident into the highest tax rate of 7.15% regardless of filing status.