The State of Opportunity Zone Investing

PROFESSIONALS

Blake E. Christian

PRACTICE AREAS

Opportunity Zones

Tax

Blake Christian, Tax Partner
January 30, 2019

Press Contact
Blake Christian
T: 435.200.9262
F: 435.200.9277
blake.christian@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) effective in 2018 and operative up to the next three decades.

Beginning January 1, 2018, through December 31, 2026, individuals, corporations, REITs, and pass-through entities can sell their appreciated capital assets and elect to reinvest the resulting capital gain into a Qualified Opportunity Fund (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. State conformity to this law is varied and requires careful state-by-state analysis.

The Program offers a powerful and flexible tax savings and diversification tool for taxpayers generating capital gains. To participate, taxpayers must roll all (or a portion) of their capital gains (whether short-term or long-term) into a QOF. The QOF must then timely (180-day window discussed below) invest the gain into undeveloped or developed real estate, a new or existing QOZ-based business, or into other qualified QOZ property. While most of the focus is on real estate projects, the Program also provides significant potential benefits for taxpayers investing in active businesses that operate primarily within a QOZ. A future sale of an active business at multiples of 6- to 8-times EBITDA can easily eclipse a healthy real estate appreciation.

This reinvestment window is a critically important step in participating in the Program. Generally, partners in a partnership, shareholders in an S Corp, beneficiaries in certain trusts and investors in REITs are deemed to receive their allocable share of taxable income on the last day of the partnership's taxable year, or December 31 for the calendar year entities. Partners in partnerships that do not make the QOZ deferral election at the entity level can make the deferral election on their personal income tax return for their share of the capital gains on Form 8949.

For purposes of the 180-day window, the clock starts ticking on December 31st for these types of gains and these taxpayers may defer all or a portion of their capital gains recognized in the calendar until June 2019 by setting up and funding a QOF.

Although all states have QOZ census tracts, the Program allows each state to elect whether or not they want to conform to the federal QOZ provisions. Currently, only 28 states and the District of Columbia[1] have elected to conform to the federal QOZ tax provisions.

Opportunity Zone State Issues

While the federal Program offers tremendous tax planning opportunities, the state ramifications can be a minefield for the uninformed. When choosing an investment within 8,700 census tracts (plus U.S. Territories) and various specific QOFs, state tax planning is imperative. As noted, only half the states have fully embraced the Program, and as such, taxpayers may still incur a tax liability in their home state, and potentially in other states if the QOF makes national investments.

Example 1: Opportunity Zone Treatment – Conforming Resident State

Assume a Michigan resident (a conforming QOZ state) reinvests a $1,000,000 gain from the sale of a Michigan asset into a QOF that then invests in a California real estate project. Remember, California is a non-conforming state that may allow limited project eligibility. Further, assume that the Michigan resident's investment in the QOF subsequently appreciates to $1,700,000 in year ten, the year of liquidation of the QOF investment.

Due to Michigan's QOZ conformity, tax on the original $1,000,000 gain will be deferred for federal and Michigan tax purposes. The taxpayer will have an initial tax basis of $0 in the QOF. Subsequently, the taxpayer will receive basis step-ups of 10% and 5% in years five and seven, respectively, for both federal and Michigan. In the year 2026 (the end of the deferral period for the original gain) $850,000 of the original gain will be reportable and the federal and state tax basis of the QOF will be $1,000,000. In the year 2028 (the ten-year milestone) the basis of the QOF investment will be adjusted to the fair market value resulting in no reportable gain on the subsequent sale of the QOF investment.

From a California perspective (a non-conforming state wherein the QOF investment is located), the taxpayer will start with a $1,000,000 tax basis in the QOF and no California basis adjustments will occur in years five, seven, and ten. When the QOF is sold, the $700,000 gain ($1,700,000 less $1,000,000 basis) will be fully reportable in California. The Michigan taxpayer will pay California tax on the full net gain in the year the investment in the QOF is sold. Further, since no Michigan tax is imposed on the gain, a Michigan credit for taxes paid to another state may not be available resulting in full exposure to California tax on the transaction.

Example 2: Opportunity Zone Treatment – *Non-Conforming Resident State*

As another example, a Michigan resident taxpayer that reinvests the related gain in a Hawaii (a non-conforming state) QOF ***will*** receive Hawaii tax basis in the QOF equivalent to the amount of the gain that is reinvested. However, because Hawaii is a non-conforming state, the taxpayer ***will not*** receive a step-up in basis or other favorable tax treatment when the QOF is subsequently sold. When the Hawaii related QOF is sold, the gain will generally be exempt for federal and Michigan tax purposes but will be reportable in Hawaii.

The state sourcing of the gain may differ in cases in which the investment being sold is corporate stock (an intangible generally taxed in the state of residency/ domicile) or partnership interest ("look-through" and taxed in the state where assets are located). However, a detailed discussion of these issues is outside of the scope of this article. One key item to note here is that states have specific rules that apply to the sourcing of intangibles that may generally assign gain from an intangible to the taxpayer's state of residence or they may utilize the "look-through" methodology to source the gain.

Individual, estate, trust, or business taxpayers residing or commercially domiciled in states that adopt the federal Program should consider limiting their QOZ investments to their home state or other OZ conforming states. 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 tax basis step-ups in years five, seven and ten will be available to the investor for both federal and state purposes.

Opportunity Zone Treatment – Non-Conforming Resident State

A resident of California (a non-conforming state) that makes an investment in a QOF fund that has underlying investments in a state with no individual tax regime may be surprised that California will still whittle away at their return on investment. Although the California resident ***will not*** be subject to nonresident tax in such states, he or she will still be subject to tax in California on the initial disposition of the capital asset and the subsequent sale of the QOF. That's because California taxes residents on 100% of their worldwide income, and provides a credit for taxes paid to other states (a credit that would be inapplicable in this case).

Taxpayers living in states that have not adopted the QOZ Program should evaluate entering into an IRC Section 1031 “Like-Kind Exchange” transaction instead of investing in 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).

Opportunity Zone Treatment – State Tax Conclusion

The multi-state taxation exposure gets more complicated as you expand the fact pattern to consider investments in states that impose 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.

The combination of varying state taxing regimes, tax rates, other state tax credit provisions, allocation/apportionment methodologies, and varying conformity measures with respect to the QOZ lends to a far more complicated state tax investment landscape. As such, taxpayers contemplating a QOF investment will be well served to fully consider all possible scenarios in order to understand the tax aspects of the exit scenario and its impact on the taxpayer’s investment goals, return-on-investment, and overall re-investment strategies.

[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, South Carolina, 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.

An income of $700,000 will force a Maine resident into the highest tax rate of 7.15% regardless of filing status.

About HCVT

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. For more information, they can be reached at (562) 590-9535 or BlakeC@hcvt.com and Edvin.Givargis@hcvt.com

The firm provides tax, audit and assurance, business management, and mergers & acquisition services to private companies, closely held businesses, public companies and high net worth individuals and family offices. The team consists of over 600 members, including over 100 partners and principals. HCVT serves its clients from eight offices in Southern California and offices in Northern California, Fort Worth, Texas, Park City, Utah, and Phoenix, Arizona. The firm is highly specialized and focuses on specific industries and market niches. To learn more about HCVT, see www.hcvt.com.