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Opportunity Zone Investors May See More State Tax Windfalls

By **Maria Koklanaris**

Law360 (May 1, 2019, 5:26 PM EDT) -- The conversation around qualified opportunity zones is increasingly shifting to states as practitioners say the use of federal adjusted gross income as a starting point for state taxation automatically gives investors a double tax break unless states have decoupled.

Boards covered the back of a building near a construction site in an opportunity zone in Newark, New Jersey, in this April 2018 photo. (AP)

Opportunity zones offer investors a chance to defer or even eliminate taxation of capital gains if they invest in economically distressed areas designated in every state, the District of Columbia and five U.S. territories. Congress intended such investment to spur development in areas it felt might otherwise be forgotten. Created under the 2017 Tax Cuts and Jobs Act, the opportunity zone provisions will especially affect states that have capital gains taxes and that begin their income tax calculation with federal AGI, since those states will automatically conform to opportunity zones unless they expressly opt out.

So far, only Hawaii and North Carolina have opted out, although Arkansas has moved to limit state tax breaks for opportunity zone investment, and Hawaii has legislation, pending the governor's approval, to change its law to be more similar to the one in Arkansas. As a result, some state tax professionals recognize that investors in states that use federal AGI as a starting point for calculating state income tax may get a double break, which some tout as a feature while others advise caution.

The attention focused on opportunity zones has risen so quickly that Steven Wlodychak of EY said he counts them among "the top three most disruptive events in state tax" in the last year, with the other two being the Wayfair decision and the application of the TCJA.

"This was sort of a neglected section of the code" for state tax professionals, Wlodychak said. "Nobody saw this coming. I didn't spend any time on it. Now, I see a lot of people raring to go. Are the states going to conform and provide similar incentives to invest in those zones?"

It is likely that they will. Many lawmakers may not even be aware that their states conform with the opportunity zone provisions in the TCJA, since they have focused on more contentious issues such as its cap on state and local tax deductions and the bill's global intangible low-taxed income provisions.

"Certainly the path of least resistance is just to continue to conform," said Michelle Layser, professor of taxation at the University of Illinois College of Law. "There is no real incentive for a state to fail to do so. Since so many states are conforming, I don't think that alone would be a strong incentive to invest in any particular state," but a lack of conformity could be a disincentive, she noted.

Some firms are maintaining lists and advising clients to consider state conformity while they decide where to invest. With nearly 9,000 designated opportunity zones across the nation, these firms focus on maximizing incentives and reducing the risk of having to report capital gains on state returns when opportunity fund investments are later sold.

"One thing about the state-level incentives — those incentives can lead to greater investment in that state or that particular opportunity zone than in others" that do not conform, said Michael Novogradac of Novogradac & Co. LLP, which tracks conformity and lists additional steps states may be taking to lure investment.

Bills in at least a dozen states this legislative season would sweeten state incentives for opportunity zone investments. Leading the pack is Maryland, where Republican Gov. Larry Hogan on Tuesday signed S.B. 581, which offers opportunity zone investors a variety of extra state tax credits.

Many state tax experts, however, think allowing additional state incentives to piggyback on opportunity zone incentives is a terrible idea, and believe states would be wise to decouple. Their reasoning is largely the same as has been raised with other targeted tax incentives, namely that state incentives drain coffers on behalf of a few, rather than benefiting all residents.

Moreover, it's not clear these tax breaks will have the desired effect. Policy experts ask whether investors would have invested capital even without a tax break, and note that with opportunity zone tax breaks, investment dollars may go to places that were already gentrifying. And in some cases, the breaks may hurt the people the opportunity zones were meant to help by creating incentives to push longtime residents out of their neighborhoods.

"It allows for a tax cut for wealthy individuals — we would argue that's not a good thing," said Misha Hill of the Institute on Taxation and Economic Policy. "There's no safeguard set up to ensure that the capital coming into these communities is actually going to help these communities. The concern with states going along with federal policy is that this is heightened."

But another option exists. Instead of conforming to opportunity zone provisions or decoupling from them, states could follow Arkansas' lead and limit tax breaks only to real estate and businesses in the state. It remains to be seen, however, whether that law will be allowed to stand.

Arkansas' law easily could be challenged on constitutional concerns, said Kirk Stark, professor of taxation at UCLA School of Law. He noted it is OK for states to favor in-state investments through expenditure programs, but embedding an incentive only for in-state investments into the tax code becomes constitutionally problematic.

Stark referenced the case of Cutler v. Franchise Tax Board, in which the California Court of Appeal found unconstitutional a California statute that allowed for deferral of taxation on sale of small business stock only if that stock was issued by a company with 80% of its assets used for California business and 80% of payroll in California.

"The most vulnerable statutes are those that are facially discriminatory in that they explicitly set out to benefit only in-state investments," Stark said.

With that caution in mind, states should decouple from opportunity zones, Michael Mazerov of the Center on Budget and Policy Priorities said in a blog post and in an interview with Law360. Mazerov said he wondered if state legislators other than those in Hawaii and Arkansas had thought about plans by opportunity zone funds to invest in opportunity zones in many states.

"Unless they decouple from these breaks, [conforming] states are going to be sacrificing revenue to subsidize investment that their residents are going to be making in other states," Mazerov said. "Let the federal government subsidize those investments if they want to. But states shouldn't do it on top

of that."

--Editing by Tim Ruel and Robert Rudinger.

Update: This story has been updated to reflect changes in Hawaii and North Carolina.

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