Conscious Decoupling

D&S Opportunity Zone Practice Group
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New York State has finalized its fiscal 2022 budget, which includes a significant change related to the opportunity zone program ("**OZ Program**"). Don't forget your EZ-Pass if you're a New Yorker hoping to follow the yellow brick road to the Land of OZ! A few new tollbooths have been installed. The budget includes legislation to decouple from the U.S. federal income tax deferral benefit available under the OZ Program. We unpack what this means and how this may impact New York taxpayers.

The OZ Program – A Quick Review

The OZ Program was introduced into the Internal Revenue Code ("Code") as part of the 2017 Tax Reform package. Very generally, it affords taxpayers with three potential tax benefits:

(1) Deferral of Eligible Gains: A taxpayer can defer paying tax on eligible gain that is timely reinvested in a qualified opportunity fund ("QOF"). The deferred eligible gain will be included in income on December 31, 2026, unless an inclusion event triggers inclusion on an earlier date (the "Inclusion Date").

(2) Reduction of Tax on Deferred Eligible Gains: If a taxpayer has held its QOF interest for at least five years prior to the Inclusion Date, the taxpayer can reduce the amount of its deferred eligible gain by 10% (through a step-up in basis). This means that taxpayers who invest in a QOF by December 31, 2021 can essentially get a complete forgiveness of 10% of that original deferred gain if they hold their QOF investment through December 31, 2026.

(3) Exclusion of QOF Investment Gains: If a taxpayer holds its QOF interest for at least 10 years, the taxpayer can exclude from income all of the appreciation in its QOF interest when the interest is sold (or, in the case of a qualifying asset sale, the taxpayer's allocable gain from the sale). This tax benefit is referred to as the "10 Year Benefit."

Of course, a taxpayer will only qualify for these benefits if a host of statutory and regulatory requirements are satisfied. We discuss many of these requirements here.

New York's Deferral Decoupling

New York is a "rolling" Code conformity state. This means that New York automatically conforms to federal tax rules under the Code, unless the state formally decouples from one or more particular federal tax rules. Accordingly, New York's income tax rules are generally similar to U.S. federal income tax rules, subject to certain modifications. For example, the starting point for calculating a taxpayer's New York income tax base will typically be the taxpayer's federal income tax base, which is then adjusted for specific add-backs, reductions, credits, etc.

The fiscal 2022 budget includes provisions to decouple from the deferral and reduction benefits provided under the OZ Program. This means that any eligible gain deferred under the OZ Program for federal income tax purposes will be added back to a taxpayer's New York income tax base and thereby subject to current taxation in New York. When those gains become subject to federal income tax in 2026 (or on an earlier Inclusion Date), they will be excluded from the New York tax base so that New York only taxes those gains once.

Prospective Changes Only (or Mostly)

The decoupling is effective for taxable years beginning on or after January 1, 2021. This means that any gains that would otherwise be included in income in 2020 are still eligible for the deferral and reduction benefits in New York, even if those gains have not yet been invested in a QOF. Investors generally have a 180-day reinvestment period, and investors with "K-1 gain" from a partnership can invest those gains as late as September of the following tax year. So any New York partners receiving their 2020 K-1s with allocations of capital gain can still invest those gains into a QOF in 2021 and get the deferral and reduction benefits.

However, a New York taxpayer with a 2021 gain that invested the gain in a QOF, for example, in March 2021, is not eligible for the deferral and reduction benefits even if the investment was made before the New York budget was finalized.

Consider Moving or Investing Out of State at Your Own Peril

The addback and exclusion regime for calculating New York taxable income does avoid double taxation for taxpayers that are subject to tax in New York both in the year of the gain and the year of the Inclusion Date. Unfortunately, this does <u>not</u> prevent double state taxation for a New York taxpayer that is subject to tax as a resident in an OZ-conforming state on the Inclusion Date. Taxpayers should be mindful of these rules and the potential for double state taxation.

Here are a few scenarios where New York taxpayers could get caught. First, if a New York resident pays New York tax on eligible gains that are otherwise deferred under the OZ Program for federal purposes, but then changes its residency to an OZ-conforming state in a later year, the taxpayer's deferred gains might be taxed by its new state of residency when those gains are included in income for federal tax purposes in 2026 (or on an earlier Inclusion Date).

Likewise, a resident of an OZ-conforming state will generally have to pay New York tax on eligible gains arising from the sale of real property in New York, even if those gains are deferred under the OZ Program both for purposes of federal tax and the taxpayer's resident state tax. However, the taxpayer's state of residency may tax 100% of those deferred gains when they are included in income for federal tax purposes in 2026 (or on an earlier Inclusion Date). A similar outcome would result for a New York resident with deferred gains from the sale of property outside New York. To the extent the states involved do not give a credit for previously taxed deferred gains (and we are not aware of any that do), this is a recipe for double state taxation.

How Could this New Legislation Play Out for NY Taxpayers?

Some examples may help to illustrate the effect of the decoupling:

- Phyllis lives in New York and realized eligible gains from the sale of property in New York in 2020. Phyllis timely reinvested those gains into a QOF in 2021, and the gains qualified for deferral under the OZ Program. Phyllis's deferred gains will be deferred for both federal and New York State income tax purposes until the applicable Inclusion Date. At that time, the deferred gains will be included in income for both federal and New York tax purposes (subject to reduction of tax, depending on how long Phyllis has held her QOF interest).

- Jim lives in New York and realizes eligible gains from the sale of property in New York in 2021. Jim timely reinvests those gains into a QOF, and the gains qualify for deferral under the OZ Program. Jim's eligible gains will only be deferred for federal income tax purposes, and will be subject to New York income tax in 2021. On the applicable Inclusion Date, the deferred gains will be included in Jim's income for federal income tax purposes (subject to reduction of tax, depending on how long Jim has held his QOF interest), and excluded from income for New York tax purposes.

- Dwight realizes eligible gains from the sale of property in New York in 2021, while he is a New York resident. Dwight timely reinvests those gains into a QOF, and the gains qualify for deferral under the OZ Program. Dwight's eligible gains will only be deferred for federal income tax purposes, and will be subject to New York income tax in 2021. In 2022, Dwight moves to Pennsylvania, where he becomes a beet farmer. On the applicable Inclusion Date, the deferred gains will be included in income for federal income tax purposes (subject to reduction of tax, depending on how long Dwight has held his QOF interest). Assuming that Pennsylvania has not decoupled from the OZ Program and does not otherwise offer a credit for previously taxed deferred gains, the deferred gains will also be included in income for Pennsylvania tax purposes.

The 10-Year Benefit

Interestingly enough, under the statutory text of the budget, New York has not decoupled from the OZ Program with respect to the 10 Year Benefit (for now, at least). Accordingly, gains from the sale of a QOF interest (or applicable asset sale) may still be eligible for exclusion from income for both federal and New York income tax purposes. We are closely watching this issue for any new developments.

The D&S Opportunity Zone Practice Group brings together a 50-person team, including lawyers, paralegals, and our business professionals providing a unique value add for clients. The OZ team is led by:

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