taxnotes® state

Volume 93, Number 3 ■ July 15, 2019

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Reprinted from *Tax Notes State*, July 15, 2019, p. 181

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In this installment of Noonan's Notes, the authors discuss qualified opportunity funds and qualified Opportunity Zones and examine how a high-tax state like New York treats the deferred income tax benefit of a taxpayer who moves out of the state.

There's been a good amount of buzz surrounding the qualified Opportunity Zones (QOZs) that were created by the Tax Cuts and Jobs Act. The federal law created preferential tax treatment for investments in QOZs through qualified opportunity funds.[1] The QOZs were designed to encourage investment in economically distressed communities in the United States through these tax benefits, and because state income taxes often follow federal taxes, these QOZs could provide significant state tax benefits as well.

But these incentives require that the investment be held for anywhere from five to 10 years. A lot can change over the course of a decade, including a taxpayer's state residency. Anytime we help taxpayers with long-term planning, we're reminded of the famous John Lennon lyric, "life is what happens to you while you're busy making other plans." Taxpayers frequently move between states, and considering the limits on the state and local tax deduction imposed by the TCJA, we're seeing even more taxpayers move from high-tax states (New York, New Jersey, and California) to low- or no-tax states (Florida, Texas, and Arizona) than ever before. And even if taxpayers aren't moving for tax reasons, unforeseeable events, such as a medical emergency, can cause taxpayers to move from states with harsh winters to more temperate climates (as lifelong Buffalonians, we know harsh winters).

So this begs the question, if a taxpayer is holding an investment to eventually receive favorable federal tax treatment, how would a high-tax state like New York treat the deferred income tax benefit of a taxpayer who moves out of the state? In this article, we'll examine this important state tax question. But first, let's briefly review the Opportunity Zone program and its benefits.

Qualified Opportunity Zone Overview

QOZs are low-income communities that are nominated by their respective jurisdictions — states, the District of Columbia, or U.S. possessions.[2] Governors of each jurisdiction may designate up to 25 percent of these low-income communities as QOZs.[3] These communities generally have a poverty rate above 20 percent and a median family income

[1] IRC sections 1400Z-1 and 1400Z-2, added by the Tax Cuts and Jobs Act, P.L. 115-97, section 13832.

[2] IRC section 1400Z-1.

[3] *Id.*

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that is less than 80 percent of the statewide median, for census tracts outside metropolitan areas, or less than 80 percent of the metropolitan area median or statewide median, for census tracts in a metropolitan area.[4]

To receive preferential tax treatment, the taxpayer must invest in a QOF, organized for this purpose. The QOF must be in the form of a U.S. corporation or U.S. partnership, including a U.S. limited liability company that is treated as a partnership or corporation for federal income tax purposes.[5] The QOF must then invest in QOZs, and it must hold at least 90 percent of its assets in QOZ property, including QOZ business property, partnership interest, or stock.[6] The QOF investment must be purchased for cash, and must be treated as equity (not debt). However, the equity can be in the form of preferred stock or a preferred partnership interest with special allocations. There is no requirement that the taxpayer literally invest the actual proceeds from the sale giving rise to the gain (like a 1031 exchange), nor is there any restriction on borrowing additional monies to supplement the gain funds to make a qualifying investment.

Qualified Opportunity Zone Benefits

To be eligible for the tax benefits, the taxpayer who recognizes taxable capital gains as a result of a sale or exchange of property must invest, within 180 days of the sale or exchange, all or a portion of the amount of the gain in a QOF.[7] The taxpayer is then eligible to receive three distinct benefits — tax deferral, tax deferral and reduction, and tax elimination — depending on how long the investment is held. Below is a review of each benefit.

Tax Deferral

A taxpayer can avoid being subject to federal income tax on the recognized capital gain in the year it was incurred and instead be subject to federal income tax on that gain (less any decline in the fair market value of the qualified Opportunity Zone investment) on December 31, 2026, or if earlier, at the time of the disposition of its interest in the QOF.[8] Gain from sales of property after December 31, 2026, is ineligible for the tax deferral benefit.[9]

Tax Deferral and Reduction

When the deferred gain must be taxed (that is, December 31, 2026, or earlier), the taxpayer can obtain up to a 15 percent discount on the federal income tax due. Specifically, the amount of gain that is taxed is reduced by 10 percent of the total gain amount if the QOF investment is held for at least five years before the end of the deferral period (earlier of December 31, 2026, or date of sale of investment).[10] This requires that the QOF investment be made by December 31, 2021, and be held until December 31, 2026. The amount of gain that is taxed is reduced by 15 percent if the investment is held for seven years before the end of the deferral period.[11] This requires that the investment be made by December 31, 2019, and be held until December 31, 2026.[12]

Tax Deferral and Elimination

So if the taxpayer holds the QOF investment for at least 10 years, at the time of the sale or exchange of the QOF investment before December 31, 2047, the taxpayer's basis in the QOF investment is treated as equal to the FMV on the date it is sold or exchanged.[13] Thus, the taxpayer would not have to recognize any gain on the appreciation in the QOF investment from

[4] IRC section 45D(e). A census tract that is not a low-income community may still be designated as a QOZ if it is contiguous with a low-income community that is designated as a QOZ and has a median family income of less than 125 percent of that of the contiguous community. But this is limited to 5 percent of the census tracts designated.

[5] IRC section 1400Z-2(d).

[6] IRC section 1400Z-2(d)(2)(A).

[7] IRC section 1400Z-2(a).

[8] IRC section 1400Z-2(a). The proposed regulations clarified that only capital gains may be deferred, and the gain cannot arise from the sale or exchange with a related person. Prop. Treas. reg. section 1.1400Z-2(a)-1.

[9] IRC section 1400Z-2(a)(2)(B).

[10] IRC section 1400Z-2(b)(2)(B)(iii).

[11] *Id.*

[12] IRC section 1400Z-2(b).

[13] IRC section 1400Z-2(c).

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the sale or exchange. It should be noted that this benefit is available only to investments for which the tax deferral benefit has been elected.[14] Since the tax deferral benefit expires at the end of 2026, this appears to preclude post-2026 investments in QOFs from qualifying for this tax elimination benefit.

New York Impact on Opportunity Zone Planning

Like many states, New York's personal income tax is calculated beginning with federal adjusted gross income.[15] Modifications are then applied to arrive at New York AGI.[16] This reference to federal AGI results in New York taxing the same income as the federal government if there is no applicable modification.

To put it another way, if income is not taxed federally, it will not be taxed for New York purposes unless a statutory modification compels a different result. And regarding the new federal Opportunity Zones, there is no special modification addressing the calculation of Opportunity Zone-related income. Consequently, the benefits a taxpayer receives from investment in an Opportunity Zone at the federal level should also be received for New York state tax purposes.[17]

New York's Accrual Rule Generally

But what happens to a state taxpayer if circumstances change — particularly if residency changes — during the deferral period? Here is where the Opportunity Zone rules can intersect with New York's infamous "accrual rule." This isn't the first time we've written about accrual, but we will give a brief overview.[18]

[14] Prop. Treas. reg. section 1.1400Z-2(c)-1(a).

[15] N.Y. Tax Law section 612(a).

[16] N.Y. Tax Law sections 612(b) and (c).

[17] According to the New York State Department of Taxation and Finance, "the deferral or exclusion of gain [at the federal level] will flow through to New York State and is estimated to cost New York approximately $7 million per year." New York State Department of Taxation and Finance, "Preliminary Report on the Federal Tax Cut and Jobs Act," 35 (Jan. 17, 2018).

[18] Joseph N. Endres and Timothy P. Noonan, "Watch Out for New York's Accrual Rule," *State Tax Notes*, Aug. 4, 2008, p. 343.

Generally, nonresidents and part-year residents pay income tax only on those items of income sourced to New York.[19] But when a taxpayer changes her filing status from resident to nonresident, Tax Law section 639(a) requires that she include any income that accrued to her before the change of residence.[20] As such, the taxpayer must attribute items of income, gain, loss, or deduction to her former state of residence if she had the right to receive those items before the move.[21] This rule basically ignores that as a cash-basis taxpayer, the former resident does not receive payment until after she changes her residence status, and essentially transforms a cash-basis taxpayer into an accrual-basis taxpayer. This also works the other way around: A taxpayer who changes her filing status from nonresident to resident must include in her nonresident period any income that has accrued before the date of her move into New York.[22] And it applies to changes in residency from New York City.[23]

The regulations provide that the taxpayer must include in her income "all items required to be included if a Federal income tax return were being filed for the same period on an accrual basis."[24] To determine when the accrual occurs, both the tax department and New York courts generally rely on the all-events tests provided in Treas. reg. section 1.446-1(c)(ii)(A).[25] Under this test, income is "included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy."[26] Moreover, as a practical matter, New York has adopted the all-events test because the instructions to New York's Form IT-225-I — the

[19] N.Y. Tax Law section 601(a).

[20] N.Y. Tax Law section 639(a).

[21] *Id.*

[22] N.Y. Tax Law section 639(b).

[23] N.Y.C. Admin. Code section 11-1754(c).

[24] 20 NYCRR 154.10(a).

[25] New York Advisory Opinion TSB-A-16(1)I (Mar. 15, 2016); and Treas. reg. section 1.446-1(c)(ii)(A) ("Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.").

[26] *See Matter of Blanco*, 723 N.Y.S.2d 558, 560 (3d Dep't 2001).

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form taxpayers use to modify their income due to special accruals — state that income accrues to the taxpayer when she has "an unrestricted right to receive it" and "the amount becomes fixed and determinable."[27]

The typical example of when the accrual rule plays out is in the installment sale context. For instance, if a taxpayer sells stock in ABC Corp. on January 1, 2019, on an installment basis while he is still a New York resident, but he moves to Florida in April 2019 before getting any of the installment payments, the tax department would take the position that the entire gain is accruable to his 2019 residence period and fully taxed, even though he received the cash when he was a nonresident.

As noted above, this rule can also come into play in a move-in situation, assuming the all-events test is met. One particularly infamous case involved a taxpayer who sold her Connecticut home before moving into New York City, but didn't receive the cash from the deal until after she moved in, simply due to a delayed closing.[28] The taxpayer there argued that because the sale documents were complete and all contingencies to the deal satisfied before she moved in, the accrual rule protected the gain from New York state and city tax. The judge disagreed, however, holding that under the all-events test, there was no completed sale until the closing, and the risk of loss was retained by the taxpayer until then. To repeat an oft-too-repeated joke by one of our colleagues, this accrual rule is most definitely "a cruel rule."[29]

The Accrual Rule Meets Opportunity Zones

Here's a hypothetical: Madge, a New York resident, sells shares of stock of her closely held corporation in January 2019. The sale generates a gain of $1 million. In March 2019 Madge reinvests $1 million in an investment fund with no connection to New York. In April 2019, she sells her New York home and moves to Florida.

Under these facts, if the investment fund is not a QOF, Madge includes the $1 million gain on the resident portion of her 2019 part-year resident return, and that $1 million of gain is subject to full New York tax. If, however, the investment fund is a QOF, the $1 million gain is deferred for federal income tax purposes. Moreover, because New York follows the federal treatment — again, there is no specific modification dealing with Opportunity Zone investments — Madge's gain should also be deferred for New York tax purposes and reported when the gain gets reported for federal income tax purposes.

The potential problem for Madge is that the initial gain was generated while she was still a New Yorker. So, is this like an installment sale, requiring that Madge accrue her potential New York tax on the way out the door in 2019? Or is there something unique about the federal Opportunity Zone rules that short-circuit the accrual process?

Of course, this is all new, so there's no guidance on the issue. And there's a dearth of guidance about the accrual rule generally. But if you've soldiered on this far in the article, we'll try to at least give it a go. As discussed above, under the all-events test, income is "included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy."[30] Here, the right to receive the income is not in question — the $1 million gain was actually received by the taxpayer and was simply deferred under the special federal rules because it was reinvested in an QOF. So, there's a good case that the taxpayer has the right to the gain.

But can we say that the amount of the income is determinable with reasonable accuracy? That could be more of a stretch, because the actual amount of the gain is uncertain at the time of the taxpayer's move from New York to Florida. For example, under the QOZ program, if the taxpayer liquidates her investment in the QOF before five years have elapsed, the full $1 million may be recognized

[27] New York Form IT-225-I, Addition Modification A-115, at 5.

[28] Glenna Michaels, Division of Tax Appeals (April 2012).

[29] Credit to Mark S. Klein, partner, Hodgson Russ LLP.

[30] *See Matter of Blanco*, 723 N.Y.S.2d at 560.

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for income tax purposes. If, however, the taxpayer liquidates her investment in the QOF after more than five years have elapsed but before seven years have elapsed, then $900,000 may be recognized for income tax purposes. Finally, if the taxpayer liquidates her investment in the QOF after more than seven years have elapsed, then only $850,000 may be recognized for income tax purposes. All these circumstances are possible, and because of these varying circumstances it becomes harder to argue that at the time Madge moves to Florida, the amount of the gain she can expect to receive from the sale of shares in her company can be determined with reasonable accuracy.

Of course, then, the real story here is that while varying amounts of the gain will be taxed federally depending on the amount of time the QOF investment is held, New York may never be able to tax any of the $1 million gain! If all or a part of the deferred gain is recognized while the taxpayer is a Florida resident, New York should be unable to tax it because the origin of the gain is from the sale of a nonbusiness intangible asset. Such assets are sourced to the taxpayer's domicile — in this case, Florida, which, conveniently for Madge, has no state income tax. So, the QOZ program may allow New York resident taxpayers to avoid New York tax on gains realized before a change of residence if those gains are not recognized under the QOZ program until after they move out of state.

One final note of caution. It is critical to recognize that Madge has escaped New York tax because the income at issue was not sourced to New York. Remember that nonresidents still pay tax to their former states if the income at issue is sourced to the former state. Our hypothetical works because the income at issue was a nonbusiness, intangible asset. If we change the facts slightly so that our hypothetical taxpayer invested the gain in a QOF that does business in New York, or if our hypothetical taxpayer invested in QOZ property located in New York and these investments resulted in gains, then New York would be able to tax at least a portion of those gains because some gains would be sourced to New York. Alternatively, if the initial gain resulted from the sale of assets in a New York business, then the taxpayer might also have to take that into account when determining the potential state taxes due on the deferred gain.

Conclusion

In our previous article on New York's accrual rule, we referenced Al Pacino's famous quote in *The Godfather, Part III* — "just when I thought I was out, they pull me back in!" — to illustrate that in some circumstances, former New York residents were being pulled back into the state to face a hefty tax bill. But based on the analysis here, Al might be spared by an intelligent investment in a QOF. Taxpayers looking to use these new Opportunity Zones as an effective federal tax planning tool should not overlook the potential state tax benefits that could result as well. ■

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