

Opportunity Zones in Washington State

House Finance Committee
September 13, 2019

David Duvall, Legislative and External Affairs Liaison
Jack Brumbaugh, Tax Policy Specialist
Washington State Department of Revenue

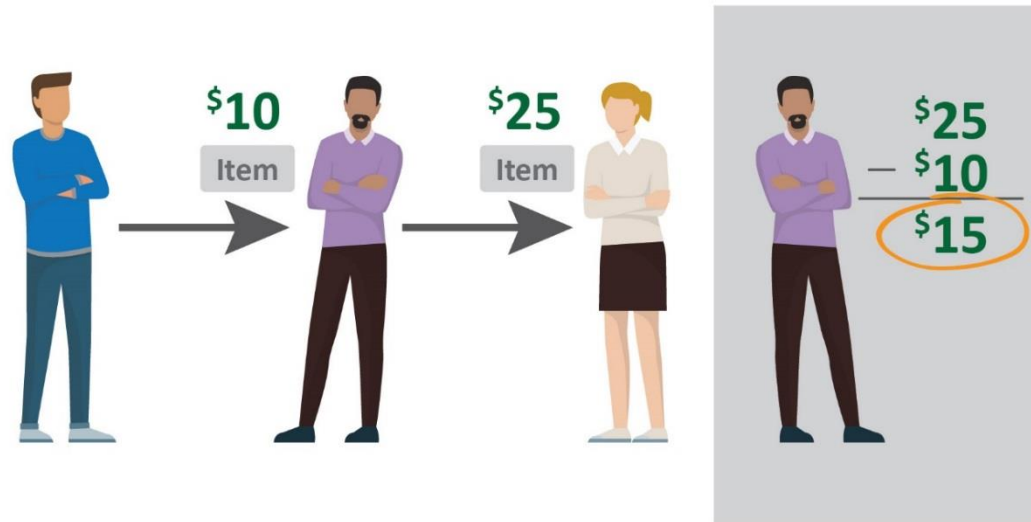


*"Working together to
fund Washington's future"*

What are capital gains?



Is it a gain or loss?



Property Sale or Exchange

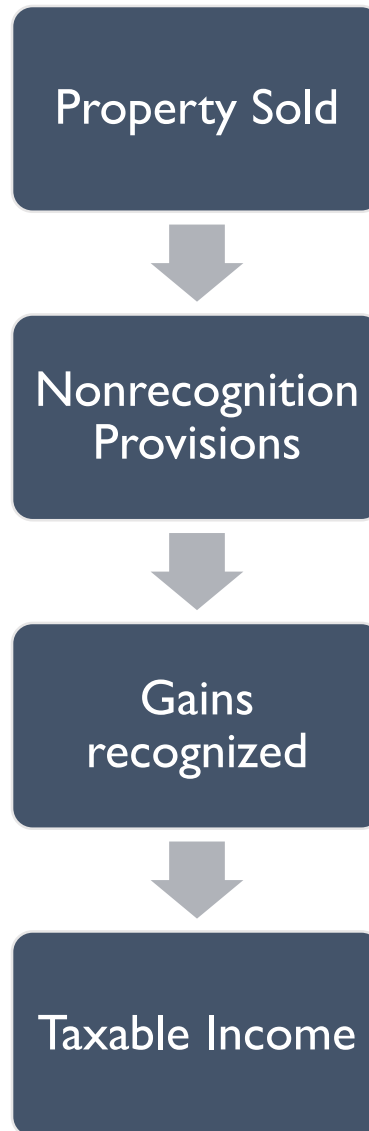
Gain

Amount realized from the sale of property exceeds the adjusted basis of that property.

Loss

Adjusted basis of property sold exceeds the amount realized from the sale of that property.

Is the gain taxable?

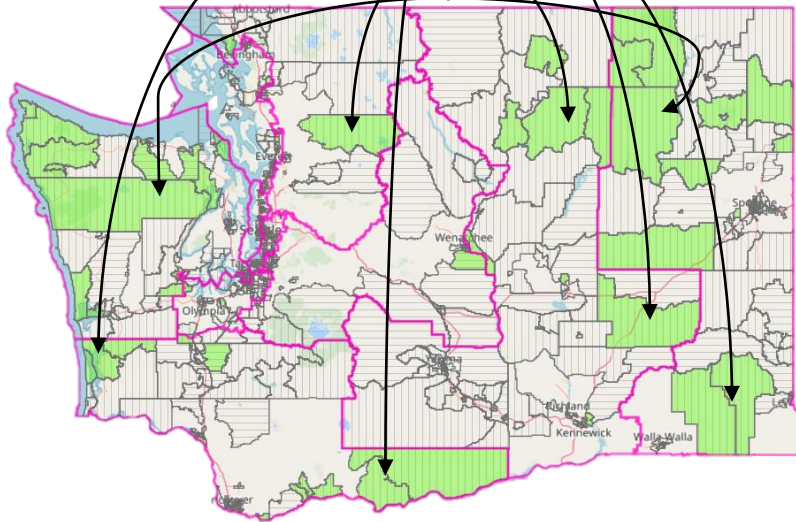


The federal opportunity zone (“FOZ”) program 26 U.S.C. 1400Z-2

Long-term capital gains



SCHEDULE D (Form 1040)	Capital Gains and Losses
Department of the Treasury Internal Revenue Service (99)	▶ Attach to Form 1040 or Form 1040NR. ▶ Go to www.irs.gov/ScheduleD for instructions and the latest information. ▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions	
15 Net long-term capital gain or (loss) . Combine lines 8a through 14 in column (h). Then go to Part III on the back	
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H	



Counties with opportunity zones

Adams	Columbia	Grant	Kittitas	Pacific	Spokane
Asotin	Cowlitz	Grays Harbor	Klickitat	Pend Oreille	Stevens
Benton	Douglas	Island	Lewis	Pierce	Thurston
Chelan	Ferry	Jefferson	Lincoln	Skagit	Walla Walla
Clallam	Franklin	King	Mason	Skamania	Whatcom
Clark	Garfield	Kitsap	Okanogan	Snohomish	Yakima

*As of December 14, 2018 per IRS Notice 2018-48 updated by IRS Notice 2019-42

Still under development...



The FOZ program important dates

- Effective since January 1, 2018
- Deferral program expires December 31, 2026
- Exemption program expires through divestment, the investment fund dissolving, or legislative change to the program.

Definitions

Eligible Taxpayers

- Individuals; C corporations; partnerships; S corporations; trusts; estates; and certain other pass-through entities

Opportunity Zone

- An economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.

Qualified Opportunity Fund

- An investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a Qualified Opportunity Zone.

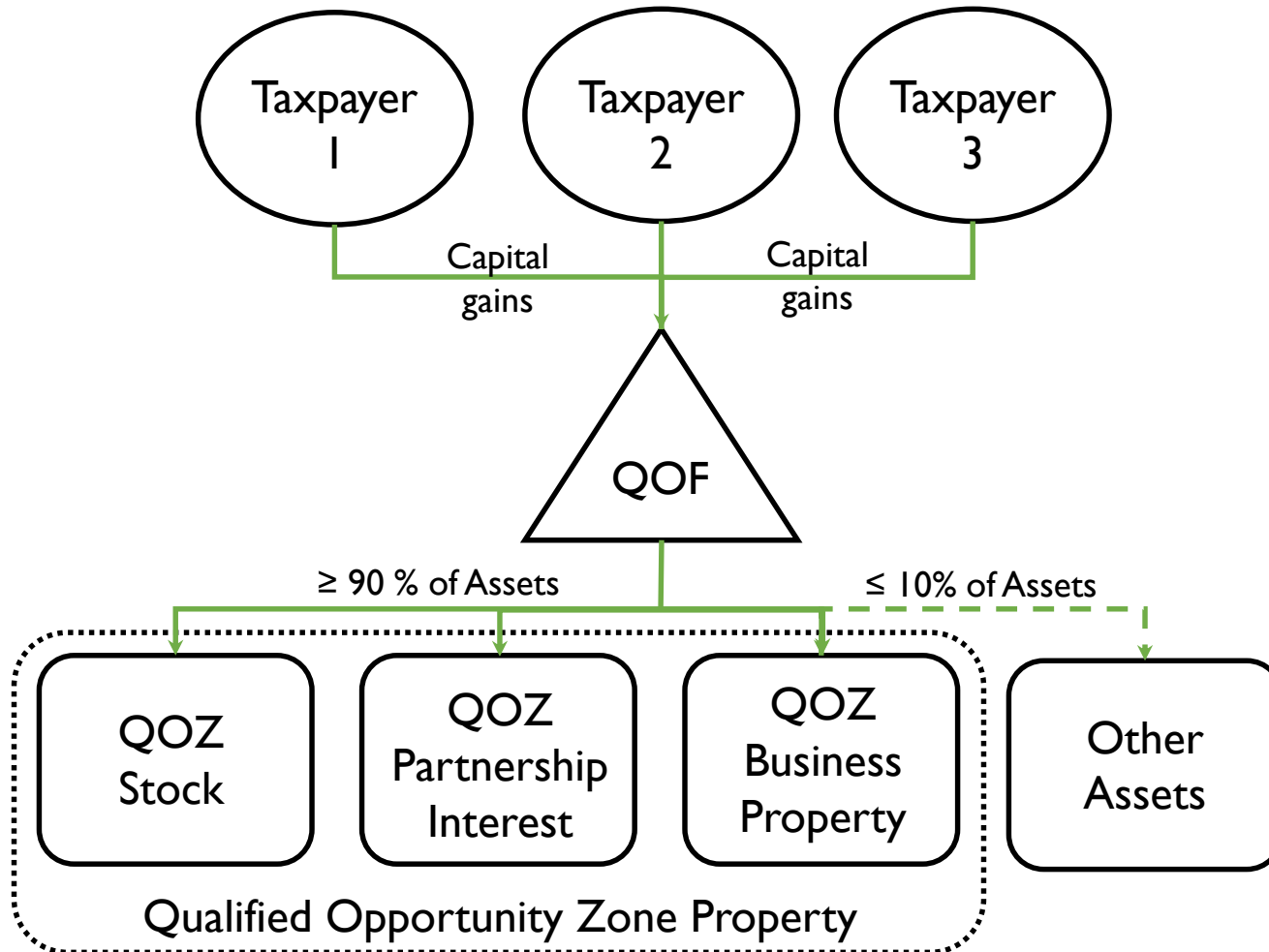
Qualified Opportunity Zone Property

- Qualified Opportunity Zone Stock – stock of a domestic corp. meeting certain requirements
- Qualified Opportunity Zone Partnership Interest - capital or profits interest in a domestic partnership meeting certain requirements
- Qualified Opportunity Zone Business Property - tangible property used in a trade or business of a QOF meeting certain requirements

Source: 26 U.S.C. 1400Z-2(d)(2)

How does it work?

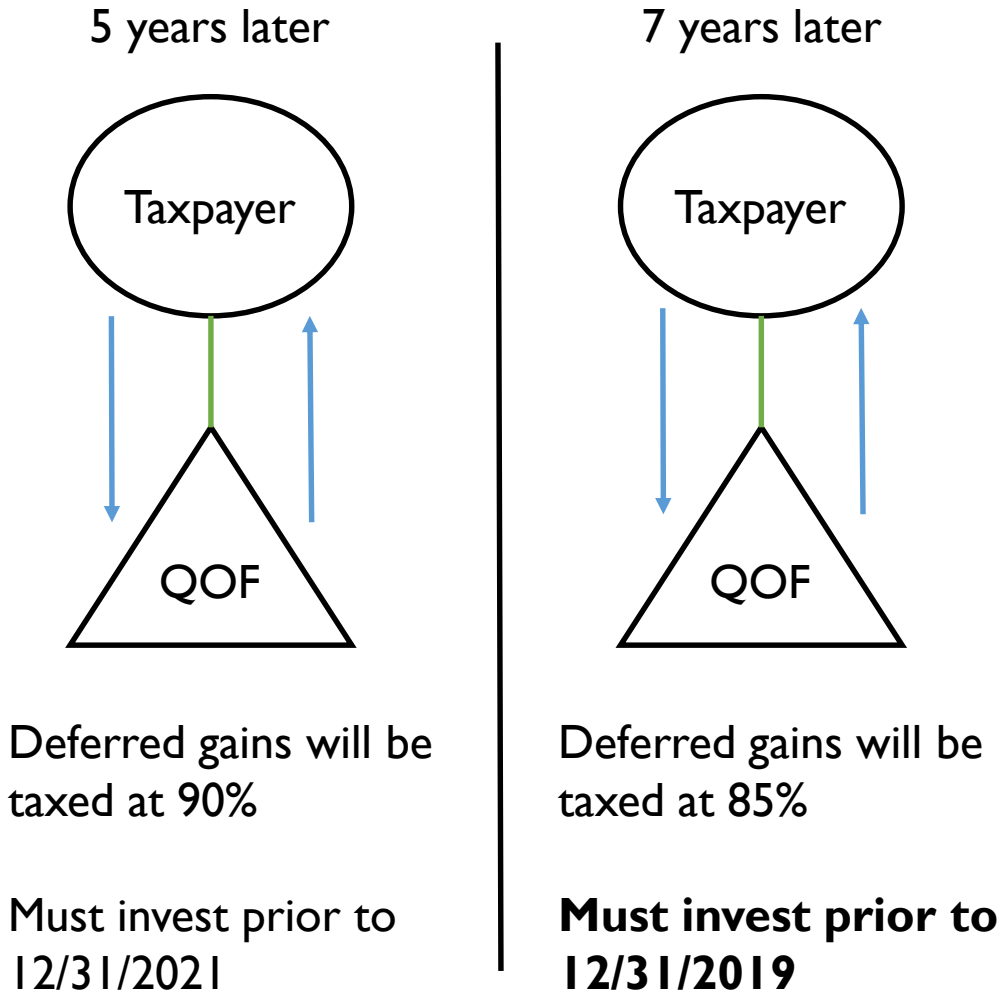
The Investment



QOF = Qualified Opportunity Fund

How does it work?

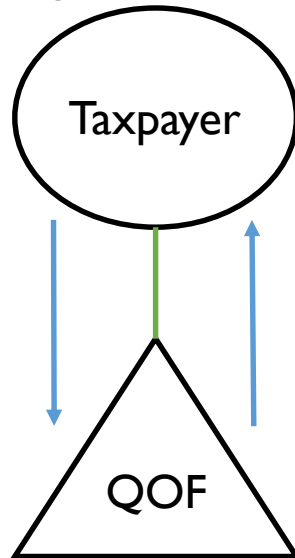
The Benefit – Part I, Deferred gain basis step-up



How does it work?

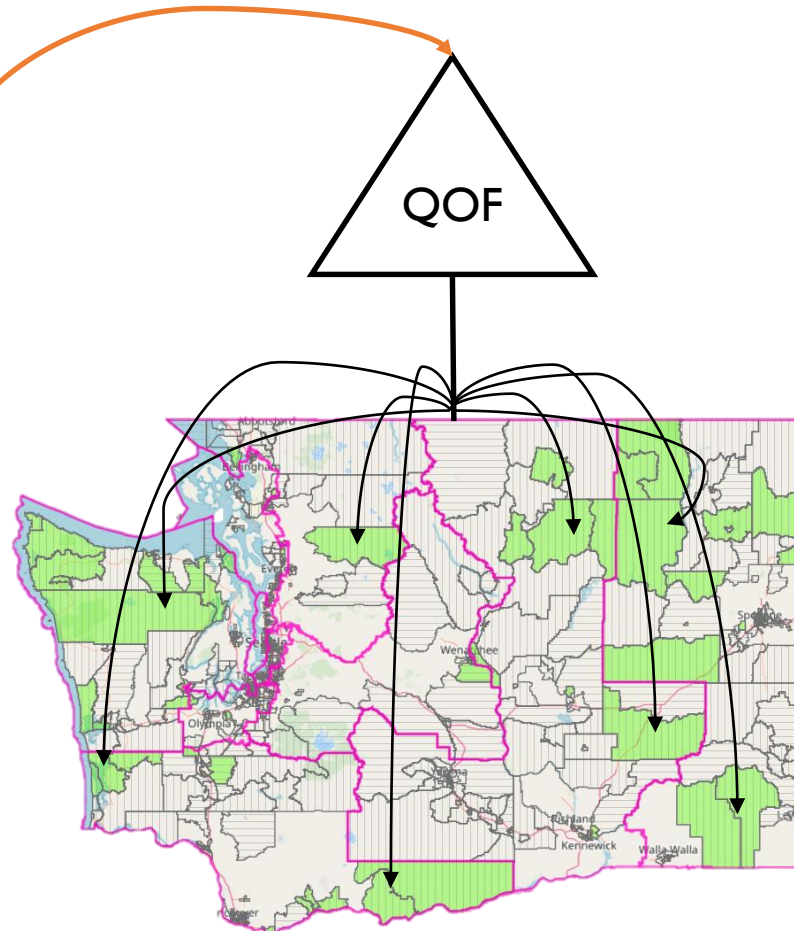
The Benefit – Part 2, Exemption

At least 10
years later



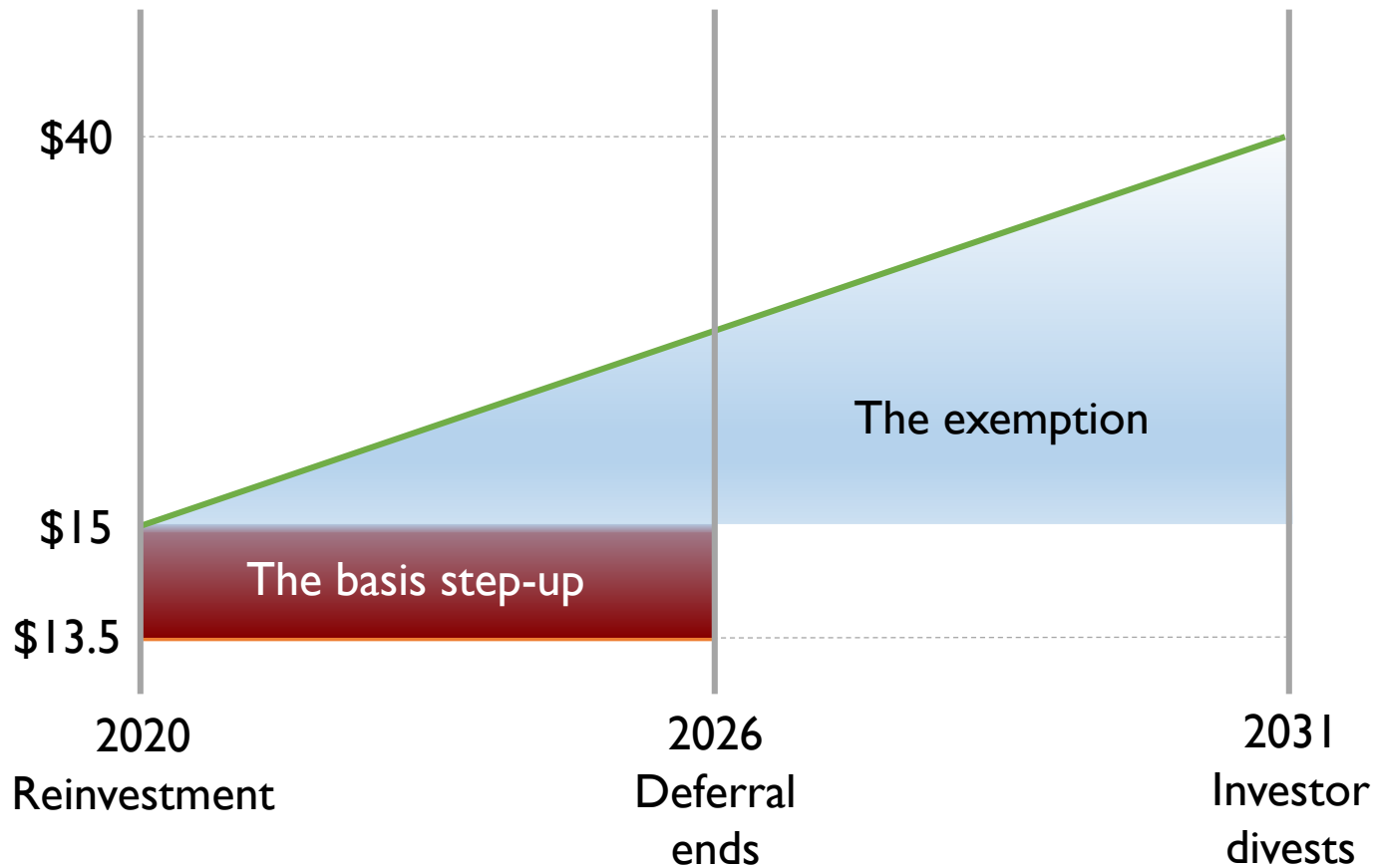
Recognize deferred gain (incl. basis increase) and receive an exemption for previous 10+ years of gain

The benefit in practice



The benefit in practice

After at least ten years



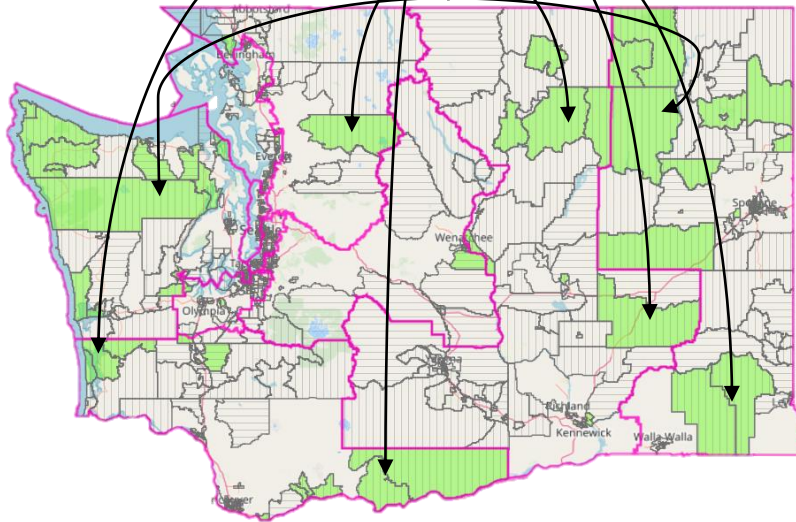
The benefit in practice

After at least ten years

	Without FOZ program	With FOZ program
Total tax bill	\$9.5	\$3
Value in 2031	\$40	\$40
Effective tax rate	23.8%	7.5%

FOZ program recap

Long-term capital gains



SCHEDULE D (Form 1040)	Capital Gains and Losses
<small>Department of the Treasury Internal Revenue Service (99)</small>	<small>▶ Attach to Form 1040 or Form 1040NR. ▶ Go to www.irs.gov/ScheduleD for instructions and the latest information. ▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.</small>
Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions	
15 Net long-term capital gain or (loss) . Combine lines 8a through 14 in column (h). Then go to Part III on the back	
<small>For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H</small>	

Possible scenarios for the state

1. WA could do nothing.
2. WA could pass an excise tax on capital gains and incorporate the FOZ tax benefits into that tax.
3. WA could pass an excise tax on capital gains and de-link the FOZ tax benefits from that tax.
4. WA could create a tax preference tied to investments in opportunity zones.

Scenario 1: WA does nothing

- Taxpayers would still receive federal-level tax benefits.
- WA would see no direct change in tax revenues.

Scenario 2 & 3: WA imposes an excise tax on capital gains

- If WA were to impose an excise tax on capital gains, the Legislature could incorporate the FOZ tax benefits into its tax.

Scenario 2 & 3: Computation of state-level capital gains

- The starting point for WA capital gains is an individual's federal net long-term capital gains.

SCHEDULE D (Form 1040) Department of the Treasury Internal Revenue Service (99)	Capital Gains and Losses ▶ Attach to Form 1040 or Form 1040NR. ▶ Go to www.irs.gov/ScheduleD for instructions and the latest information. ▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.	OMB No. 1545-0074
		2018 Attachment Sequence No. 12
Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)		
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions	14	()
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then go to Part III on the back.	15	
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H Schedule D (Form 1040) 2018		

- The federal taxable amount will need to be adjusted for any state-specific adjustments.
- FOZ tax benefits will already be included in federal net long-term capital gains.

Scenario 2: incorporating the FOZ program

An individual will not make a state-level adjustment for the FOZ program because any deferrals, exemptions, or inclusions will be included in the individual's federal net long-term capital gains amount.

Consider the following examples...

Scenario 2: Incorporating the FOZ program (Ex. I)

Assume 5% annual return on QOF investment

		Taxable Event	Federal level capital gains	State level capital gains
2020 Asset value \$ 1 million	Initial Sale of Capital Asset		+ 1,000,000	+1,000,000
	Reinvestment of gains in QOF		- 1,000,000 (Deferral)	- 1,000,000 (Deferral)
	Taxable Gains		0	0
		Taxable Event	Federal level capital gains	State level capital gains
2022 Investment value \$ 1.1 million	Sale of QOF interest		+ 102,500	+ 102,500
	Recognitions of Deferred Gains		+ 1,000,000 (Previously deferred)	+ 1,000,000 (Previously deferred)
	Taxable Gains		1,102,500	1,102,500
Total taxable gains			1,102,500	1,102,500

Impact
<ul style="list-style-type: none"> • WA will not receive tax revenues until capital gains are recognized at the federal level. • Total taxable gains are the same over the course of the investment.

Scenario 2: Incorporating the FOZ program (Ex.2)

Assume 5% annual return on QOF investment

		Taxable Event	Federal level capital gains	State level capital gains
2020	Asset value \$ 1 million	Initial Sale of Capital Asset	+ 1,000,000	+1,000,000
		Reinvestment of gains in QOF	- 1,000,000 (Deferral)	- 1,000,000 (Deferral)
		Taxable Gains	0	0
		Taxable Event	Federal level capital gains	State level capital gains
2031	Investment value \$ 1.7 million	Sale of QOF interest	0 (Exempted)	0 (Exempted)
		Recognitions of Deferred Gains (2026)	+ 900,000 (Previously deferred)	+ 900,000 (Previously deferred)
		Taxable Gains	900,000 (2026)	900,000 (2026)
		Total taxable gains	900,000 (2026)	900,000 (2026)

Impact

- WA will not receive tax revenues until capital gains are recognized at the federal level.
- Total taxable gains are the same over the course of the investment.

Scenario 3: De-linking FOZ program

An individual would need to make the following adjustments to their federal net long-term capital gains when computing WA capital gains:

- Increase WA capital gains by the amount deferred at the federal level.
- Decrease subsequent-year capital gain amounts when deferred gains are recognized at the federal level.

Consider the following examples...

Scenario 3: De-linking FOZ program (Ex. 1)

Assume 5% annual return on QOF investment

		Taxable Event	Federal level capital gains	State level capital gains
2020	Asset value \$ 1 million	Initial Sale of Capital Asset	+ 1,000,000	+1,000,000
		Reinvestment of gains in QOF	- 1,000,000 (Deferral)	0
		Taxable Gains	0	1,000,000
		Taxable Event	Federal level capital gains	State level capital gains
2022	Investment value \$ 1.1 million	Sale of QOF interest	+ 102,500	+ 102,500
		Recognitions of Deferred Gains	+ 1,000,000 (Previously deferred)	0
		Taxable Gains	1,102,500	102,500
Total taxable gains			1,102,500	1,102,500

Impact
<ul style="list-style-type: none"> • WA receives tax revenue in the same year as a taxable transaction. • Total taxable gains are the same over the course of the investment.

Scenario 3: De-linking FOZ program (Ex. 2)

Assume 5% annual return on QOF investment

		Taxable Event	Federal level capital gains	State level capital gains
2020	Asset value \$ 1 million	Initial Sale of Capital Asset	+ 1,000,000	+1,000,000
		Reinvestment of gains in QOF	- 1,000,000 (Deferral)	0
		Taxable Gains	0	1,000,000
		Taxable Event	Federal level capital gains	State level capital gains
2031	Investment value \$ 1.7 million	Sale of QOF interest	0 (Exempted)	+ 710,339
		Recognitions of Deferred Gains (2026)	+ 900,000 (Previously deferred)	0
		Taxable Gains	900,000	710,339
Total taxable gains			900,000 (2026)	1,710,339

Impact

- WA receives tax revenue in the same year as a taxable transaction.
- Total taxable gains in WA are nearly double the total federal taxable gains.

Scenario 2 & 3: Comparison of taxable gains (at least 10 years of investment)

	Incorporating the FOZ program	De-linking the FOZ program
	State level capital gains	State level capital gains
2021	\$0	\$1,000,000
2026	\$900,000	\$0
2031	\$ 0	\$ 710,339
Total	\$900,000	\$1,710,339

Fiscal impact of de-linking the FOZ program

During the 2019 legislative session, the Department estimated that de-linking the FOZ program from a hypothetical state capital gains tax would have a significant positive revenue impact—approximately 4% over the next 5 years.

Scenario 4: Tax preference for investments in opportunity zones.

WA could create a tax preference for investments in opportunity zones.

Potential stacking of benefits

Federal opportunity zone program

1. A federal level deferral, and possible exemption, for capital gains invested into Qualified Opportunity Funds.
2. Possible equivalent benefit at the state level if a hypothetical WA capital gains tax incorporates the FOZ program.

Rural development and opportunity zone program (proposed in HB 1324 (2019))

3. A B&O tax/insurance premium tax credit for making capital contributions to a Rural Development and Distressed Opportunity Zone Fund.

For more information:

David Duvall

Legislative & External Affairs Liaison

Washington State Department of Revenue

[Email: DAVIDD@dor.wa.gov](mailto:DAVIDD@dor.wa.gov)

Phone: (360) 534-1545

Questions?

