

**As Signed by Governor
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Ohio Budget HB 166 Contains Income Tax Credit for Investments in Qualified Opportunity Zone Funds

The Ohio Budget bill (HB 166) has been passed by the Ohio House and the Ohio Senate and contains an identical opportunity zone (OZ) income tax credit. The House and Senate passed their separate versions of this bill on May 9 and June 20, respectively. However, the bill has stalled due to the differences in other provisions of the House and Senate versions. Because of the identical OZ tax provisions in both bills, the current pending provision could be the form that eventually comes through Conference, but it could change in Conference. This summary discusses the pros and cons of the OZ provision in its current pending form and the open questions.

Background. The February 2019 version of SB 8 has been modified to become more robust in providing an Ohio income tax credit for investments in designated Ohio opportunity zones. The earlier version of SB 8 was discussed in a February 20, 2019 summary, The upgraded version was initially passed by the Ohio Senate on April 3 and that bill was then folded into the current budget bill (HB 166).

As passed by the Ohio House and Senate, the OZ provisions increased the initial tax benefits available but retains procedures for submitting applications for approval by the Ohio director of development services and places a cap on the aggregate income tax credits that can be issued to all taxpayers and a cap on the aggregate amount that can be issued to any one taxpayer, with both such caps applying for a two year period. Dropped is the requirement linking a portion of the Ohio tax credit to the level of tax collections from additional economic activity generated by the Ohio Qualified Opportunity Fund (“OQOF”) investment.

Supplements Federal Tax Benefits that Are Equally Applicable for Ohio Taxes. The Ohio income tax credit supplements the tax benefits provided pursuant to the federal income tax provisions that also are applicable for Ohio income tax purposes. In other words, the federal income tax benefits of (1) deferring the taxation of capital gain invested in a Qualified Opportunity Fund (“QOF”), (2) the partial exclusion of the deferred capital gain of up to 15%, and (3) the tax-free appreciation for investments in a QOF would carry over with a similar benefit available for Ohio income tax purposes.

The Ohio income tax credit available pursuant to HB 166 would be applied against a taxpayer’s Ohio income tax liability from all sources. The following lists pros and cons of the pending Ohio OZ income tax credit and related questions.

PROS

1. Tax Credit Increased to 10% of the Investment in the QOF.

Question: The credit is 10% of the investment in the QOF that is invested during the preceding year *in projects* located in an Ohio OZ. The Ohio provision accepts that the typical approach is for the QOF to transfer the cash received into a second-tier entity (“OpCo”) in exchange for an equity interest. A question is what is required by the language that the cash amount is *invested in projects* located in an Ohio OZ and whether the 10% is calculated only for the amount that is considered *invested in a project* annually.

As discussed further below, pursuant to the federal income tax proposed regulations an OpCo can apply cash received over a period of years (as is permitted by the 31-month safe harbor provided by the IRS guidance). A question is whether the full credit is available in the first year that the QOF invests the amount in an OpCo entity (whether such action can be considered the *investment in projects located in an Ohio OZ*) or whether the Ohio tax credit is spread over the multiple years that the invested dollars are spent towards a specific project. As it stands, this is an interpretive question to be addressed by the Ohio Development Services Agency.

2. Carry Forward of Unused Tax Credit. The Ohio income tax credit can be carried forward for five years following the first year of eligibility.

Question: What is the first year that the Ohio income tax credit can be claimed, which starts the additional five-year carry forward?

Similar to the question above regarding when the 10% calculation is taken into account, the Ohio income tax credit can be claimed in the first calendar year in which the QOF invests “*in a project located in an Ohio OZ.*” This linkage is taken from the term “qualifying taxable year” that references the QOF investment in a project located in an Ohio OZ.

In the same manner as explained above, it is unclear whether the first year of eligibility requires breaking ground, purchasing tangible property or disbursing cash, or whether the QOF investment in an OpCo is sufficient. For federal income tax purposes, a 31-month safe harbor period is permitted with respect to the development of a business, including the acquisition, construction, and substantial improvement of tangible property, and requires a written schedule of the budgeted expenses when the QOF invests in OpCo. The mere designation of a project might not qualify as *an investment in the project* for purposes of the Ohio income tax credit.

Question: The pending Ohio tax credit provision states that the credit can be claimed for the first calendar year in which the QOF *invests in a project* located in an Ohio OZ “or the next ensuing year.” Why is there a reference to the “next ensuing year?”

The Ohio Legislative Service Commission Fiscal Note and Local Impact Statement explains the reference to “the next ensuing year” is applicable where the Ohio tax credit is approved after the tax filing deadline for the year that the investment is made.

3. Original \$250,000 Minimum Investment Threshold Eliminated.

4. Application in Pass-through Entity Context.

The bill clarifies that the Ohio income tax credit process can be initiated by a pass-through entity (i.e., partnership, LLC, S corporation) that invests in an OQOF, with the certificate issued to the pass-through entity. The credit can be claimed by the individual, trust, or estate who are investor(s) in such entity on the last day of the calendar year in which the OQOF *invests in a project* located in an Ohio OZ based on such person’s proportionate or distributive share. If possible, the OQOF investors should not change during the period that a project is under construction to avoid questions regarding the application of this provision.

Having the pass-through entity initiate the approval process for the Ohio income tax credit seems efficient. The investor in the pass-through entity is required to attach the approval certificate issued by Ohio with his tax return and presumably showing the proportionate share of the credit that can be claimed by such investor.

5. Transferability of Unused Tax Credit. Taxpayers investing in an OQOF may transfer the Ohio income tax credit (evidenced on a certificate issued by the Ohio director of development services) to another person. Taxpayers who would like to transfer the Ohio income tax credit must notify the Ohio Department of Taxation in writing, with an identification of the certificate number and the transferee’s name and tax identification.

Future guidance should confirm the following points:

- a. Whether a new tax credit certificate is issued to the transferee.
 - b. Whether a taxpayer may transfer either all or part of the unused tax credit.
 - c. In the context of a pass-through entity that makes an investment in the OQOF, whether only the pass-through entity to whom the tax credit certificate is issued can transfer the tax credit or whether each member is able to transfer its proportionate share of the tax credit.
- The transferred tax credit is eligible for the remaining five-year carry forward period. The Ohio income tax credit may be transferred only once.

Exchange markets might be developed to allow for the purchase and sale of unused transferable credits.

Federal Income Tax Considerations regarding Transferable State Income Tax Credits.

- i. Confirm that the receipt of a transferable state income tax credit is not included in gross income with respect to the remaining unused portion for the year first available.
- ii. Consider whether the sale of a transferable state income tax credit can generate capital gain (short term or long term), rather than ordinary income.
- iii. Consider that the purchaser could have capital gain when the purchased tax credit is applied against Ohio income taxes in an amount greater than the initial cost, because of the discounted purchase price.

6. Eligible Taxpayers. The tax credit can be claimed by individuals, trusts, and estates.

7. Qualifying Investments in OQOF. As with prior versions of this Ohio proposal, investments in an OQOF are eligible for the Ohio income tax credit, even though such investment is not linked to capital gain dollars.

While this seems as an enhanced value, most investments in OQOF will be made to take advantage of the federal income tax benefits. To the extent that both capital gain dollars and non-capital gain dollars are invested in an OQOF, the investment of the additional dollars will dilute the federal tax free appreciation available. This dilution has a direct impact if the same person invests both forms of dollars into a OQOF.

8. OQOF Investment Reporting. The Ohio director of development services is required to submit a report by August 1 of each year to Ohio governmental leadership with information provided through the certification process for the preceding year.

CONS

1. Application Process The pending bill retains an application process through the Ohio Development Services Agency for taxpayers making OQOF investments. The application must be submitted by the taxpayer between January 1 and February 1 of the calendar year immediately following the *investment in projects* located in Ohio OZs. As discussed above, same questions arise with respect to whether disbursement of dollars to a project is needed to start and be eligible for the tax credit annually.

The application for the tax credit must include an officer or employee statement (no longer from a CPA) certifying the investment amount and describing each project and the amount of the taxpayer's investment in each project. Again, it is to be determined whether the permitted approach of the proposed IRS regulations for a schedule showing how the funds will be deployed over a 31-month period could be helpful to providing the required information.

The applications are reviewed in the order received.

There continues to be no discretion applied by the Ohio director of development services to the issuance of tax credit certificates.

2. Caps on Aggregate Ohio Tax Credit Issued and With Respect To Each Applicant.

For any two-year period, the Ohio director of development services is limited to issuing \$50 million in aggregate tax credit certificates and no one applicant (including transferees of an applicant) can claim more than \$1 million in tax credits.

In the context of a pass-through entity, it is unclear if the \$1 million cap per applicant is applied at the entity level or at the investor member level.

To the extent that the 10% Ohio income tax credit would provide a taxpayer with a credit that exceeds \$1 million for any one year, the excess would seem unavailable and not eligible for the five-year carryforward nor eligible for being transferred to another taxpayer. There might be a question whether the Ohio Development Services Agency can issue a certificate for the excess balance of the tax credit amount for the subsequent two-year period.

3. Timing of Tax Credit Certificate Issuance.

Within 60 days after receipt of a complete application, the Ohio director of development services is to issue a certificate to the taxpayer stating the credit amount for the preceding tax year. The tax credit certificate is to be attached to the taxpayer's tax return.

The 60 day period is a tight schedule and with the processing based on the order received, it is critical that applications are submitted in very early January. The bill seems to contemplate that the certificate might not be issued timely for tax return filing purposes and be used for the following tax year.

4. No Overlap with Ohio Small Business Tax Credit. Any investment for which an Ohio small business certificate (which also offers a 10% tax credit) has been issued is ineligible for the Ohio OZ zone tax credit. Correspondingly, the Ohio small business income tax credit will not be available for any investment for which an Ohio OZ investment certificate has been issued.

5. All Qualifying Property Investments and Use Must Be in Ohio Opportunity Zone. The definition of an OQOF follows the definition of a QOF from the federal Opportunity Zone tax provisions, but with the additional restriction that (a) all (rather than substantially all) of the tangible property must be "qualified opportunity zone business property" and (b) all (rather than substantially all) of the tangible property must be used in a qualified opportunity zone. HB 166 provides that "all" is substituted for "substantially all" everywhere throughout Section 1400Z-2 of the Internal Revenue Code. This could be a significant limitation in certain situations.

While guidance provided by the IRS proposed regulations regarding the definition of "qualified opportunity zone business property" and future clarification regarding when tangible property is

considered used in an OZ might be helpful, the following are examples where the substituted “all property” requirement can deny the Ohio tax credit, even though the federal tax benefits are available.

Ex. 1. An operating partnership whose interests are owned primarily by a QOF is engaged in a service business that uses movable equipment (e.g., a landscaping or roofing company). Beside services and equipment use within the opportunity zone, the business performs one job outside the opportunity zone and uses the equipment. The federal requirement that substantially all of the use of the tangible property be within a qualified opportunity zone would be met but the Ohio HB 166 requirement would not be met because of the equipment used outside the zone. Future IRS guidance regarding the use of movable equipment might be equally helpful for Ohio purposes to treat such use as being within the OZ.

Ex. 2. A QOF invests directly in an operating business that develops and provides software and biomedical licensing to businesses outside of the Ohio OZ. The intellectual property is transferred by downloading the software through the internet or through a license arrangement of the technology. HB 166 requires that “all of the use of the property was in an Ohio opportunity zone.” The federal rule permit these arrangements without violating the “substantially all” requirement. Hopefully, the HB 166 OZ income tax credit provisions are applied in the same manner.

Use of Multiple QOFs. When considering whether to use separate QOFs for each OpCo investment, an additional reason arises when investing in both Ohio and non-Ohio OZ projects. The Ohio income tax credit requirement that all qualifying property investments and use must be in Ohio OZs mandates that separate QOFs be used for Ohio OZ projects versus non-Ohio OZ projects.

When reviewing supplemental tax benefits available in other States, similar consideration should be given to the separate requirements for the additional tax benefits available in each State.

6. Effective Date. As a bill for the “appropriation for current expenses,” the Ohio tax credit should go into effect immediately. A question is whether the Ohio income tax credit would be available only for investments after such date and not for investments during the earlier part of 2019.

Taking this question a step further, tying the Ohio income tax credit to when there is an “*investment in a project*” (as stated in the pending bill and discussed above) could further delay the time to claim the credit to much later than when the federal income tax benefits commence. Depending on the interpretation given by the Ohio Development Services Agency to the meaning of “*an investment in a project*,” it could be that such point does not occur until the dollars are spent toward a project, rather than when the dollars are transferred by the OQOF to an OpCo and the 31-month safe harbor period commences.

For many investments in an OQOF made during the first half of 2019, the dollars might not be applied towards a specific project until after the effective date of the pending bill, which would allow the new credit to be available.

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