October 11, 2018

Representative Kirk Schuring
District 48
77 S. High St
14th Floor
Columbus, OH 43215

Hello Representative Schuring:

Thank you for introducing HB 727 that would provide an Ohio income tax credit at a rate of 10% for investments by individuals (or pass-through entities owned by individuals) in federally designated Opportunity Zone Funds. An Ohio tax credit would provide an appreciable enhancement of the federal income tax benefits, which could be viewed as immediate, more substantial, and easier than the federal tax benefit and generate a higher interest for investments in designated Ohio low income communities. However, the reason for my letter is to raise two starting points with respect to the availability of the proposed credit. The first point is to raise an awareness that the mechanics of the tax credit has a potential substantial limitation for taxpayers that could prevent the full use of the proposed Ohio tax credit and prevent its intended purpose. The second point relates to how the $250,000 threshold is applied in the context of a pass-through entity.

I. FACT THAT CREDIT CAN BE CLAIMED ONLY FOR THE TAX YEAR IN WHICH INVESTMENT IS MADE CAN RESULT IN NONUSE OF A SUBSTANTIAL PORTION OF THE CREDIT. .

As drafted, the tax credit is nonrefundable (i.e., it is limited to the Ohio income tax liability for the year that the investment is made) and any unused tax credit amount for the year of the investment is not available as a carry over to a future year and is lost. The application of these limitations is magnified when the gain deferral available pursuant to the federal tax benefits is taken into account.

Consideration should be given to revisions to increase the opportunity for the full use of the proposed Ohio tax credit to at least match the timing of the deferred gain recognition. The simplest approach would seem to be a carryover of the proposed Ohio tax credit through at least 2026, which is the final year that the deferred gain pursuant to the federal tax provisions would be recognized for federal income tax purposes. A second approach is to allow the investor to elect not to have deferred gain for Ohio tax reporting, even if an election is made to have deferred gain for federal income tax purposes. The second approach would still need to be

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combined with a carryover of any unused credit to maximize its effectiveness. A third approach that could be added to the first two would be to permit the proposed Ohio tax credit to be applied against the deferred gain in the year incurred, rather than the year the investment is made, provided that a federal election is in effect for the use of the Opportunity Zone provisions.

This substantial limitation on the use of the proposed Ohio tax credit can arise in multiple situations. The situations are described below, along with examples illustrating the problems and possible solutions.

A. Effect of Deferred Gain. A current federal tax benefit is that the taxation of gain can be deferred (by an election) when sale proceeds related to such gain is invested through an Opportunity Zone Fund within 180 days. The deferred gain for federal income tax purposes also results in a deferral for Ohio income tax purposes. Ohio income starts with federal adjusted income and deferred gain is excluded in determining federal adjusted income. The effect of the deferred gain is that the Ohio tax liability for the year of the investment can be substantially less and there can be a high likelihood that the full use of the proposed tax credit is unavailable.

In this situation, individuals might be forced to choose between electing not to have the federal tax benefit apply to avoid deferred gain so that the gain (and resulting Ohio income tax) is taken into account in full immediately and eligible for the proposed Ohio tax credit.

It would be most beneficial for investors to have both the federal and Ohio tax benefits, which I would expect was contemplated when drafting the Ohio bill. .

Example #1: In November 2018, an individual sells stock and has $1 million of gain, which is invested in a qualified Opportunity Fund. The investor makes an election to defer the gain pursuant to the federal tax provisions.

Besides the $1 million of gain, the investor also has $300,000 of compensation income for 2018. Let's assume that the Ohio income tax liability on $300,000 is $15,000 (5%). The Ohio tax liability will actually be lower.

The proposed Ohio tax credit is $100,000 (10% of $1 million investment). As written, only $15,000 of the proposed Ohio tax credit would be available (because that is the 2018 Ohio income tax liability) and the balance is lost.

The tax credit is not available against the Ohio tax on the deferred gain (approximately $50,000--$1 million times 5%) because such gain was not recognized in 2018--the year of the Opportunity Zone Fund investment.

The approaches of allowing a tax credit carryover through 2026 and allowing the individual to elect out of the deferred gain for Ohio purposes helps the use of the proposed Ohio tax credit.

B. Investment Does Not Need to be Tied to Gain. The proposed Ohio benefit is available to any investment of $250,000 or more in a Opportunity Zone Fund, regardless of whether the taxpayer has gain that generated cash that was used to obtain the federal tax benefit and regardless of whether an election is made for federal income tax purposes. Under certain circumstances, investors can merely use borrowed or saved cash to make a qualifying investment to get the proposed Ohio tax credit.

In this situation, the proposed Ohio 10% tax credit would not be available because the investor has insufficient Ohio tax liability for the year of the investment.

Example #2: In November 2018, an individual borrows $1 million (or a pass-through entity uses $1 million of cash available) to invest in a Opportunity Zone Fund. Because there is no gain from a property sale that generates the funds for the investment, no federal benefit is available.

The investor has $300,000 of compensation income for 2018. Let's assume that the Ohio income tax liability on the $300,000 is $15,000 (5%). The Ohio tax liability will actually be lower.

The proposed Ohio tax credit available is $100,000 (10% of $1 million investment). As written, the proposed tax credit that could be used is limited to $15,000 (because that is the 2018 Ohio income tax liability) and the balance is lost.

The approaches of allowing a tax credit carryover through 2026 helps the use of the proposed Ohio tax credit. Otherwise, the individual needs an additional $1.7 million of 2018 Ohio income (resulting in an additional $85,000 of Ohio tax liability) to fully use the proposed tax credit.

C. Timing of Ohio Tax Credit. The proposed Ohio tax credit is available only in the tax year when the Opportunity Zone Fund investment is made. The federal tax benefit provides taxpayers with flexibility to wait 180 days following a property sale to invest the gain amount. The effect of the federal provisions is that the investment could be made in a tax year following a property sale that generates the deferred gain

Because the proposed Ohio tax credit is available only for the year that the investment is made, such credit would not be available against the deferred gain that arose in the year prior to an investment in a Opportunity Zone Fund.

Example #3 Same as example #1, but the investment in an Opportunity Zone Fund is made in February 2019 (four months following the property sale that generates the deferred gain). The proposed Ohio tax credit would need to be claimed in 2019 and not be available against the 2018 deferred gain.

The multiple solutions of allowing a tax credit carryover through 2026, allowing the individual to elect out of the deferred gain for Ohio purposes, and allowing the Ohio proposed tax credit to be available against the 2018 deferred gain would be most beneficial to maximize the Ohio benefit and make the investment opportunity most attractive.

The proposed Ohio tax credit can be very important to decisions of whether to invest in Opportunity Zone Funds and could allow for an influx of money during the balance of 2018. The mechanics of the proposed Ohio tax credit, if enacted, could cause investors to limit their investments to amounts that generate a useable Ohio tax credit, even though the credit available could be much larger.

II. APPLICATION OF CREDIT TO PASS-THROUGH ENTITIES.

The proposed tax credit would be available only to taxpayers who invest $250,000 in Opportunity Zone Funds. Taxpayers that are subject to an income tax against which the credit would be available are individuals, trusts, and estates. At issue is how is the $250,000 threshold applied when the investment if made by a pass-through entity.

Assume that a partnership having six partners invests $1 million in an Opportunity Zone Fund. When determining whether the taxpayer(s) have invested the required $250,000 amount, is this determination applied at the partnership level or at the individual partner by allocating a proportionate amount of the partnership investment? The later approach would not meet the $250,000 threshold in this situation. The question focuses on the fact that the individuals (rather than the partnership) are the taxpayers who are subject to the Ohio income tax against which the tax credit would be applied.

The simplest solution would be to clarify that partnership investments (as well as investments by any pass through entity) would be tested against the $250,000 threshold, rather than at the individual level. If the bill text remains as written, the lack of clarity could prevent investments . The following points can be made in support of the position that pass-through investment is the appropriate testing point:

A. The proposed bill states that nothing limits or disallows pass-through treatment of investments made by a pass-through entity. This statement can be interpreted to mean that the level of the requisite investment is determined at the pass through entity level.

B. The ORC defines “taxpayer” to include pass-through entities that file a composite income tax return. However, would not want to trip someone solely on whether or not a composite pass-through Ohio tax return was filed.

Hopefully, the suggested revisions can be added and appropriate legislative action taken to allow the proposed Ohio tax credit to be available with respect to 2018 investments. After more thought and the issuance of IRS guidance that is expected this month, I would expect that further comments will be raised but the above two seem basic to making the proposal viable.

I hope this detail is useful. I would like the opportunity to discuss and can be reached at 937-443-6740.

Frank Ferrante