SHOP TALK

Oregon Treatment of Opportunity Zone Investment

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The December 2017 federal tax reform law, commonly referred to as the Tax Cuts and Jobs Act or TCJA, included the new opportunity zone ("OZ") tax benefit. This article discusses Oregon's incorporation of the OZ tax regime. In particular, this article focuses on the interplay between the federal requirements for the investment exit, the general structure of an OZ investment, and the Oregon rules for taxing nonresidents on the sale of entity interests. As discussed below, because Oregon would not have taxed nonresidents on gain from a sale of an OZ investment, conformity ensures that Oregon tax law does not disincentivize Oregonians from investing in Oregon OZs.

OZ tax regime: general summary

A detailed discussion of the requirements for an OZ investment is beyond the scope of this article, and readers should be aware that the new regime has several moving parts with many issues remaining ambiguous despite two rounds of detailed proposed regulations issued by the Internal Revenue Service.

In general, the OZ regime allows for (1) deferral until 2026 of capital gain,\(^1\) (2) elimination of up to 15 percent of the deferred capital gain,\(^2\) and (3) no tax on appreciation for the investment of the deferred gain if the taxpayer holds the investment for at least 10 years.\(^3\) For an OZ investment, a taxpayer must invest capital gain from the sale of property in a partnership (including an LLC taxed as a partnership) or a corporation (including an S corporation) that elects to be treated as a qualified opportunity fund ("QOF").\(^4\)
To qualify as a QOF, 90 percent of the QOF's assets must consist of "qualified opportunity zone property," which consists of "qualified opportunity zone stock," a "qualified opportunity zone partnership interest," or "qualified opportunity zone business property." As the IRS acknowledged when it released the first round of OZ proposed regulations, the property ownership requirements for an OZ investment incentivize a two-tier structure, in which a QOF will own qualified opportunity zone stock or a qualified opportunity zone partnership interest, rather than directly owning qualified opportunity zone business property. Generally, this two-tier structure will consist of (1) a QOF that is an LLC treated as a partnership for tax purposes, and (2) a lower-tier LLC, the interests of which qualify as a qualified opportunity zone partnership interest that operates a "qualified opportunity zone business," as defined in IRC Section 1400Z-2(d)(3) ("QOZB"). The QOZB will own and operate the applicable business (e.g., newly constructed commercial rental property.)

Pursuant to the IRC, the no-tax-on-appreciation benefit only applies to the taxpayer's gain from the sale of an interest in the QOF. In the second round of proposed regulations, the IRS expanded this benefit to a taxpayer's flow-through gain from the QOF's sale of property. As a general matter, however, buyers will want to purchase assets, and not membership interests in the QOF or the second-tier QOZB entity. Nothing in the proposed regulations extends the no-tax-on-appreciation benefit to the flow-through gain from an asset sale by the second-tier QOZB partnership. Accordingly, for purposes of this article, it is assumed that a taxpayer will structure the OZ exit as a sale of interests in the second-tier entity and not as an asset sale.

Oregon's incorporation of the OZ regime

The TCJA allowed each state governor to designate a number of QOZs equal to 25 percent of the state's low-income census tracts, based on the 2010 census. For the most part, QOZs are also (or were, in the 2010 census) low-income tracts, but certain contiguous census tracts could be designated as a QOZ. Oregon has 86 QOZs. Further, Governor Brown designated all of downtown Portland (both sides of the Willamette River) and parts of the Pearl District as OZ—all areas attracting investment even absent the OZ regime. In fact, these areas were rated the sixth best OZ in the nation.

Oregon is a rolling reconnect state. That is, Oregon law automatically adopts federal tax law "related to the definition of taxable income." Of course, the Legislature can disconnect from federal changes. For example, in the legislative session immediately following enactment of the TCJA, the Oregon Legislature disconnected from the new IRC Section 199A deduction. In fact, the 2019 legislative session included a
bill, H.B. 2144, which would have disconnected Oregon from the OZ regime. This bill ultimately died in committee. Accordingly, Oregon conforms to the OZ tax benefits and will not impose tax on gain from the sale of an OZ investment if the taxpayer satisfies the 10-year holding period requirement.

**Oregon conformity protects residents because tax would not apply to nonresident's gain from an OZ investment**

Oregon taxes individual residents on worldwide income. On the other hand, Oregon taxes full-year nonresidents only on taxable income "from sources within this state." For purposes of illustration, assume a typical two-tier OZ investment in which a taxpayer (Oregon resident or nonresident) invests in a QOF that invests in a second-tier partnership that invests in Oregon real property. If Oregon did not conform to the OZ regime:

- **Oregon residents would owe tax on gain from the sale of the OZ investment.**
- **Nonresidents would owe Oregon tax on gain from the sale of the Oregon OZ investment only if Oregon tax law treated that gain as from an Oregon source.**

At first blush, in may seem that, because the underlying investment is located in Oregon, the gain would be treated from Oregon sources. This would be the case if the taxpayer structured the exit as an asset sale. As described above, however, current federal tax rules do not allow the no-tax-on-appreciation benefit for gain from an asset sale by the second-tier partnership. Instead, the QOF must sell its interests in the second-tier partnership or the taxpayer must sell his or her interest in the QOF. Accordingly, federal tax law requires structuring the exit as a sale of interests in an entity (generally, an LLC).

Or. Rev. Stat. §316.127(3) provides the rule for sourcing gain from the sale of intangible property:

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Income from intangible personal property, including annuities, dividends, interest and gains from the disposition of intangible personal property, constitutes income derived from sources within this state only to the extent that such income is from property employed in a business, trade, profession or occupation carried on in this state.
(Emphasis added.)
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Or. Rev. Stat. §316.127(3) provides a rule of limited taxation: Oregon does not tax a nonresident with respect to gain from the sale of intangible property unless the intangible property was employed in a business in Oregon.
The Oregon Administrative Rules promulgated by the Oregon Department of Revenue (the "Department") comport with the limited nature of the statute. These rules start with a general rule applicable to the sale of intangible property: "gain from the sale, exchange, or other disposition of intangible personal property [by a nonresident], including stocks, bonds, and other securities is not taxable unless the intangible personal property has acquired a business situs in Oregon." Intangible property acquires an Oregon business situs "when used in the conduct of the taxpayer's business, trade, or profession in Oregon," for example, if the taxpayer pledged the interest as collateral for an Oregon business. Despite this theoretical possibility, nonresidents making OZ investments and the QOF generally will ensure that neither the QOF interest nor the interest in the second-tier partnership acquires an Oregon business situs.

Assuming no Oregon business situs, the Department's mechanical, black-and-white rules for sourcing a nonresident's gain from a sale of an interest in an entity apply. For LLCs, the treatment depends on whether the nonresident is a member-manager:

- **Member-Manager**: Treated the same as gain from the sale of a general partnership interest. The Department's rule treats gain from the sale of a general partnership interest as Oregon-source income if the partnership does business in Oregon.
- **Not a Member-Manager**: Treated the same as gain from the sale of a limited partnership interest. The Department's rule treats gain from the sale of a limited partnership interest as not Oregon-source income "unless the limited partnership interest has acquired a business situs in this state."

Generally, a member is treated as a member-manager if the person "has a right to participate in the management and conduct of the LLC's business." For a member-managed LLC, all members are member-managers. For a manager-managed LLC, "only those persons who are both members of the LLC and are designated as a manager in the LLC's operating agreement (or elected as managers by the LLC members pursuant to the operating agreement) will be member-managers."

Accordingly, if the QOF and second-tier LLC were manager-managed (a typical arrangement) and the nonresident was not the manager of either (also typical), Oregon would not tax a nonresident's gain from a sale of the QOF or the second-tier LLC, regardless of whether Oregon conformed with the OZ regime. Oregon not conforming to the OZ regime, therefore, would have had the odd result of making an Oregon OZ investment more beneficial for nonresidents than residents.
Author's note

The February 2019 issue of the Journal included an article by the author about Oregon's treatment of the federal deemed repatriation. The author described guidance issued by the Department requiring an add-back of the IRC Section 965(c) deduction for Oregon personal income tax purposes. As noted by the author, nothing in Oregon tax law required the add-back, and the Department's guidance resulted from a misconstruction of a statute. The Oregon Legislature enacted Or. Laws 2019, ch 556 (S.B. 851) during the 2019 legislative session which, in part, retroactively changed Oregon personal income tax law to conform to the guidance issued by the Department.

1 IRC Section 1400Z-2(b)(1).

2 IRC Section 1400Z-2(b)(2). The ability to eliminate 15 percent of the gain only applies to OZ investments made by December 31, 2019. The elimination drops to 10 percent for OZ investments made after December 31, 2019, and by December 31, 2021. No gain elimination applies to OZ investments made thereafter.

3 IRC Section 1400Z-2(c). Although deferral and partial elimination are important, this no-tax-on-appreciation benefit is the key benefit for the OZ regime. This article focuses on this benefit.

4 IRC Section 1400Z-2(a)(1)(A); IRC Section 1400Z-2(d).

5 IRC Section 1400Z-2(d)(1), (2).


7 See IRC Section 1400Z-2(c) (referring to the "investment held by the taxpayer.")


9 Presumably, over the next few years Congress, the IRS, or the market will develop a solution. For example, the exit may consist of a sale of the second-tier entity to a middleman for a slight discount, immediately followed by an asset sale by the second-tier entity (now owned by the middleman).

10 IRC Section 1400Z-1(b)(1)(A); (d).

11 IRC Section 1400Z-1(e).

12 The Oregon Business Development Commission map of the Oregon QOZs can be found at https://geo.maps.arcgis.com/apps/webappviewer/index.html?id=b0c1911ad4874692be4651d7ba71e77e.


15 Or. Laws 2018, ch. 108 (S.B. 1528). In Boquist v. Dept of Rev., TC 5332, WL 1314840 (Or. Tax, Mar 21, 2019), the Regular Division of the Oregon Tax Court held that the underlying bill was not a "bill for raising revenue" and thus was not subject to the requirements of Oregon Constitution, art. IV, §18 (origination in House) or §25(2) (passage with three-fifths majority).

16 See https://olis.leg.state.or.us/liz/2019R1/Measures/Overview/HB2144.

17 See Or. Rev. Stat. §316.037(1) (imposing tax on "the entire taxable income" of resident); Or. Rev. Stat. §316.048 (defining entire taxable income of resident by reference to "federal taxable income"); IRC Section 63 (defining taxable income as "gross income," minus the deductions allowed by federal tax law); IRC Section 61 (defining gross income as "all income from whatever source derived").

18 Or. Rev. Stat. §316.037(3). This article does not discuss part-year residents.


20 Or. Admin. R. 150-316-0171(2)(b) (emphasis added).

21 Or. Admin. R. 150-316-0171(1)(a).

22 See Or. Admin. R. 150-316-0171(1)(b).


26 Or. Admin. R. 150-316-0171(2)(e).


28 Id.

29 Id. (Emphasis added.)

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