

Opportunity Zones **V** **S** 1031 Exchanges

The new program offers another route to postpone or eliminate taxable gains.

by Mark Lee Levine, CCIM, and Libbi Levine Segev

While the tax benefits of Section 1031 exchanges in commercial real estate are well-known to most real estate professionals, the new qualified opportunity zone program now offers another approach to deferring or eliminating taxable gain.

The Tax Cuts and Jobs Act of 2017, code sections 1400Z-1 and 1400Z-2, created qualified opportunity zones to encourage investment in specific economically distressed areas across the U.S. This new type of investment allows taxpayers to defer or possibly exclude capital gains from taxation.

The opportunity zone refers to investment in a qualified opportunity fund, or QOF. Opportunity zone investing occurs within a fund that is qualified under the code and regulations.

Qualified opportunity zone investments in commercial property can be similar to 1031 exchanges, to defer taxes, but the differences in tax implications can be significant when there is a disposition of the property. The dispositions might utilize an opportunity zone investment, an exchange, or a sale. Although favorable tax benefits may be generated from dispositions that are followed by investments in opportunity zone areas, this approach is only one option. Taxpayers and advisers also should examine tax-deferred exchanges, sales, and other approaches, rather than assuming that an opportunity zone is the best alternative, even if there are potential tax savings.

While this discussion focuses on real estate, related principles and issues may be applicable to investments in qualified opportunity zones in personal property as well. However, the federal tax law no longer allows 1031 tax deferral for personal property; the exchange must involve real estate.

Laws dealing with opportunity zones are being developed. The lack of well-established case law, regulations, and other guidance for investments in qualified opportunity zones creates risks — risks that should be considered carefully before investing in opportunity zones.

Alternatives When Disposing of Real Estate

The 1031 exchange program provides for non-recognition of gain or loss for exchanges of qualified, like-kind real estate. The 1031 deferral does not apply if the property exchanged is inventory property held for sale by the taxpayer.

Imagine that John owns Property X, and he is undertaking an exchange with Jane for Property Y. This is not a qualified 1031 tax-deferred exchange for John if he holds Property X primarily for sale (dealer) or if he holds Property Y primarily for sale.

An opportunity zone deferral also would not be applicable if the property in question is held primarily for sale.

If the exchange was qualified under 1031, the 1031 law allows for certain delays, such as a case where John will transfer Property X (relinquished property) immediately, but will receive the replacement property (Y), sometime in the future, within specific time limits. Opportunity zone rules also allow for a delay to invest funds in the qualified opportunity zone.

Both 1031 exchanges and opportunity zones also have restrictions when some of the parties to the transaction are related.

Deferral or Exclusion of Taxable Income

Another consideration when disposing of property, even by a sale, is the reinvestment of those funds in qualified properties in an opportunity zone. Investing in a QOF is required to gain the tax benefits under the program.

Benefits of investing in a QOF include:

- The seller, if qualified, can defer gain from the sale. For example, a taxpayer selling stock at a gain of \$1,000 can defer the tax on such gain by a proper qualified opportunity zone reinvestment.
- If the taxpayer properly invests the gain in a qualified opportunity zone via a QOF, the taxpayer could be allowed an exclusion of up to 15 percent of the deferred gain.
- If the taxpayer holds the investment in the QOF for at least 10 years, all the capital gain generated since the reinvestment can be excluded, assuming all the program requirements are met.

Section 1031 exchanges differ from QOFs in many ways:

- A 1031 investment does not require reinvestment in a specific area of the U.S., as long as it is in the U.S. Alternatively, by definition, the QOF must be in a qualified zone.
- The structure of a 1031 exchange requires a good deal of formality, dealing only with like-kind property. The type of property in a QOF has a broader range that can involve real estate or personal property. However,

both 1031 exchanges and QOFs have additional requirements. For example, QOF property must be acquired after Dec. 31, 2017.

- Section 1031 requires an investment in trade or business property, while the QOF has more flexibility.
- In a QOF, only the gain (not the full sales price) needs to be reinvested in a QOF to come within the deferral rule.
- As a rule, under 1031 exchanges, the entity transferring the relinquished property also must be the one obtaining the replacement property. For example, John could not transfer Property X under the 1031 exchange program and then have his corporation acquire the replacement property. A QOF provides more flexibility for the investor who sold, for example, a partnership interest then invested in a QOF entity.
- Delayed exchanges are permissible in some cases, which allow for the involvement of other parties and possibly an intermediary. As such, they provide 1031 transactions with flexibility. Section 1031 exchanges normally allow for a maximum of 180 days to complete the transaction, generally from the disposition date of the relinquished property, such as Property X, to a reinvestment in the replacement Property Y. The 180-day timing also can apply to the QOF in some cases. However, in the QOF, the seller can take possession and control of the cash from the sale; such cash control is not allowed in a 1031 exchange.

The QOF may have more flexibility for investors, assuming the investor is willing to move to a QOF and away from, in many cases, personal control of the assets. This lack of control also can create some liquidity issues for the investor in the qualified opportunity zone.

Costs in undertaking these transactions include those associated with being involved in a qualified opportunity zone, such as the fees charged by the QOF and the costs for the use of an intermediary in 1031.

Most dispositions are structured as sales. The sale may be formulated as a cash sale or by an installment sale, allowing the seller to spread income over time as payments are received. But an outright sale has its advantages and



drawbacks when compared to dispositions centered around the exchange or QOF.

Each approach to limiting taxes in disposing of property has its benefits under federal income tax laws. While limiting or avoiding taxes is attractive, as well as full exclusion of the gain, selling for cash improves flexibility in investing. Cash normally is available on a traditional cash sale, but not necessarily on a 1031 exchange or the QOF investment.

Other important issues to consider when choosing the form of disposition include determining management issues for the property; refinancing options; dealing with others in the investment; timing of dispositions and acquisitions; control over decisions; and the requirement to stay invested

in the qualified opportunity zone to gain tax benefits. The geographic areas to invest in and the type of property to select are additional factors with 1031 and the QOF.

While QOFs add another alternative for taxpayers and planners when considering the best approach to dispose of property, the decision is complex. The taxpayer must carefully weigh all factors, not only the tax benefits, to find the right option for a particular situation.

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Think Outside the ROI Box by Maurice Williams, CCIM

U.S. investors currently hold trillions of dollars in unrealized capital gains in stocks and mutual funds alone — a significant untapped resource for economic development. Opportunity zone funds will enable a broad array of investors to pool their resources into opportunity zones, increasing the scale of investments going to underserved areas.

The program provides investors with incentives to encourage long-term investment in low-income communities. Investors willing to put their capital to work can expect:

- A temporary tax deferral for capital gains reinvested in an opportunity fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is sold or Dec. 31, 2026.
- A step-up in basis for capital gains reinvested in an opportunity fund. The basis of the original investment is increased by 10 percent if the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years and by an additional 5 percent if held for at least seven years, excluding up to 15 percent of the original gain from taxation.
- A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in a qualified opportunity zone fund if it is held for at least 10 years. However, this exclusion only applies to the gains accrued from an investment in an opportunity fund, not the original gains.

Using the federal program regulations, high net-worth individuals and institutions will seek out qualified opportunity funds to make investments in low- to moderate-income real estate ventures and operating businesses. The funds, some of which already are capitalized, will vary in size, investment objectives,

and social impacts. At the project level, many opportunity funds will be paired with other funding incentives to fill the necessary project proforma or capital stack, such as tax increment financing, credit enhancements, and asset value write-downs. Additionally, funds are being capitalized for investments across property types, including housing, commercial and retail, mixed-use, manufacturing, industrial, and a host of operating business models.

Best Practices and Potential Pitfalls

Since the opportunity zone program is fairly new, with clarified federal regulations just released in January, not many best practices are developed to date. Community development real estate activities tend to be very complex to manage due to the various levels of human capital involved and the need for public-private partnerships to obtain the layers of collaborative funding to be successful.

Investors must be prepared to think outside the “return-on-investment box” and seek more than just a financial return when investing in opportunity zones. Social returns are just as, if not more, rewarding as a financial return — such as creating wealth without displacement and gentrification in low- to moderate-income communities of color; creating pathways for new job training and development; and catalyzing the economic turnaround of stalled community corridors. Yes, a good ROI is a must, but why not allow your investment to help improve the lives of others along the way?

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Weighing the Options

by Daniel Pessar

Should long-term real estate investors consider qualified opportunity zone investments for gains deferral instead of more traditional 1031 exchanges?

IRC Section 1031 and the newly enacted Section 1400Z-2 both allow for deferral of capital gains, but they are very different in their benefits and costs. The best approach for investors depends on factors such as their liquidity, the types of real estate they want to own, and their broader portfolio goals. Depending on an investor’s goals and profile, just one benefit or cost may lead it to choose a certain approach.

Qualified Opportunity Fund Investment

1031 Exchange

▲ May defer capital gains from many assets (even stocks) sold by an investor.	▼ Disposition of “like kind” (real) property.
▲ Can use any funds.	▼ Using disposition proceeds, must track funds to purchase replacement property.
▲ Only required to reinvest gain amount.	▼ Must reinvest total value and equity amount.
▲ Can invest in any valid QOF.	▼ Strict rules and time limits for property identification, such as 200-percent rule, three-property rule, and 95-percent rule.
▲ Allow capital gain reduction of up to 15 percent after 5- or 7-year hold and 100% after 10-year hold.	▼ No capital gain reduction.
▲ A partner in a partnership that elects not to make a QOZ investment to defer partnership-level gains can make its own deferral election for its distributive share of the gain.	▼ When a partnership elects not to do a 1031 exchange, partners cannot simply elect to do their own exchange with their distributive share of property disposition proceeds. Options to circumvent this issue, such as the drop-and-swap strategy, by which partners obtain tenancy-in-common interests in exchange for their partnership interests in advance of a planned property sale, may involve too much risk and complexity for some investors.
▲ 180 days may be just the beginning of time for investment since the QOF still has time to invest the funds and even longer for electing partners in a partnership that did not make an election.	▼ Only 180 days to close and must close on replacement properties.
▲ No advance identification of properties required.	▼ Advance identification of replacement properties.
▼ Deferral only up until 2026. In that year, investors will have tax with no corresponding income.	▲ Can defer capital gains on disposition property indefinitely.
▼ May only benefit from purchases of qualifying property (several rules to comply with at acquisition and throughout hold term).	▲ May benefit by purchasing any like-kind property (almost no rules in terms of replacement property).
▼ QOZ real estate investments require substantial improvement of the property.	▲ No additional investment required.
▼ Potential to lose benefits if not held for 10 years.	▲ Great flexibility to finance, sell, or exchange the replacement property after purchase.
▼ New law, complex structuring in certain cases, room for costly administrative errors in making election and keeping QOF in compliance.	▲ Simple process, mature industry, less room for costly administrative errors.
▼ Statute starts the 180-day clock when capital gains would otherwise be recognized and there is no indication that an investment entered into before that time would benefit from election.	▲ Reverse 1031 exchanges allow investors to close immediately on opportunities and to sell the disposition property afterwards, while still enjoying deferral.
▼ May lose certain benefits if selling QOF investment and making another election to invest gains in (another) QOF because proposed regulations do not mention an allowance for continuity in terms of the 5-, 7-, or 10-year period.	▲ Investments can be exchanged for other investments while maintaining the same deferral benefits.

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