Opportunity Zones vs. 1031 Exchanges

What is an opportunity zone?

An opportunity zone is an economically distressed area or community designated by the state in which it resides and certified by the US Department of the Treasury. The designation was created under the 2017 Tax Cuts and Jobs Act in order to stimulate growth and improvement in struggling economic areas of the country. There are approximately 8,762 designated opportunity zones nationwide as of July 2018, with zones in every US state and territory.

What is the demographic's in the Opportunity Zones?

Of the 8762 Opportunity Zones, 1858 rural census tracts, 31% average poverty rate, 14.4 % average unemployment rate, 24 million current jobs, and 1.6 million business.

A current list of opportunity zones can be found on the US Treasury's Community Development Financial Institutions Fund website.

What is a qualified opportunity zone fund?

A qualified opportunity zone fund is an investment vehicle which uses proceeds to invest in property located within a designated opportunity zone. At least 90% of the assets held by the fund must reside within the zone. Qualified funds provide an opportunity for investors to defer and potentially reduce capital gains taxes.

What kinds of properties qualify for the opportunity zone program?

In many cases, opportunity zone properties are new construction. However, there are certain circumstances under which a pre-existing property within the zone can qualify. A fund that purchases a pre-existing property must make "substantial improvements" to the property, defined as equal to the fund's initial investment into the property over a 30-month period. Therefore, if a fund were to acquire a property for $5 million, they would have to invest an additional $5 million in improvements over the next two and a half years. The substantial improvement only counts for the building portion of the value. If there was a building valued at $2.5 million, and the property was worth $2.5 million, the improvement would only have to be $2.5 million.

There are 7 sins business that are not permitted to be Opportunity Zone Business: golf courses and country clubs; massage parlors and suntan facilities; racetrack or other gambling outfits, or liquor stores

What kinds of investments can be exchanged into the program?

Unlike a 1031 exchange, there is no “like-kind” rule limiting what kind of investment can be rolled over into an opportunity zone. This means that capital gains from stocks or any other appreciated asset can be reinvested into an opportunity zone fund within 180 days of sale.

What advantages do qualified opportunity zone funds provide investors?

According to the IRS, investment into an opportunity zone fund can provide investors with significant tax advantages, and even savings, depending on how long the investment is held.

Potential Tax deferral – Taxes on capital gains that are reinvested into an opportunity zone fund can be deferred until December 31st, 2026 or until the interest in the fund is sold, whichever comes sooner.

Tax basis step up – If the investment is held for 5 years, 10% of the original gains invested become tax-free due to a step-up in tax basis. If the investment is held for 7 years, an additional 5% of the gains become tax-free. Any depreciation in the fund also decreases the tax-basis of the original investment.

No tax on appreciation – Even with the above tax advantages, the primary goal of an investment is for it to appreciate in value and provide a return. If an investment in an opportunity zone fund is held for 10 years, investors will not have to pay taxes on any return the fund realizes.

Example

John sells his Apple stock portfolio on January 1st, 2019 for a gain of $1 million.

Between January 1st and June 30th, 2019, John is eligible to reinvest those gains in a qualified opportunity zone fund.

Assume he reinvests those funds immediately.

Between January 1st, 2019 and December 31st, 2023 (<5 years from the date of her investment), John doesn't have to pay taxes on that $1 million gain unless he sells her interest in the fund, at which time he would pay taxes on the $1 million plus taxes on any appreciation in the fund investment. If the fund depreciates, he would only pay taxes on what remains of his initial $1 million.

Between January 1st, 2024 and December 31st 2025 (<7 years from the date of his investment), if John sells his interest in the fund, he will only have to pay taxes on $900,000 of his initial investment, due to a 10% step-up in tax basis, plus taxes on any appreciation in the fund investment. If the fund depreciates, he would only pay taxes on 90% of what remains of hisinitial investment.

Between January 1st, 2026 and December 31st, 2026, if John sells his interest in the fund, he will only have to pay taxes on $850,000 of his initial investment, due to an additional 5% step-up in tax basis, plus taxes on any appreciation in the fund investment. If the fund depreciates, he would only pay taxes on 85% of what remains of his initial investment.

On December 31st, 2026, John will have to recognize the $850,000 of her initial investment that is still taxable as a capital gain and pay taxes on it. He can continue holding his investment in the fund after this.

Between January 1st, 2027 and December 31st, 2028 (<10 years from the date of his investment), if John sells her interest in the fund, he will only have to pay taxes on any appreciation in the fund investment.

On or after January 1st, 2029, if John sells her interest in the fund, he will not have to pay any taxes on any appreciation in the fund investment.

While opportunity zones provide a compelling set of benefits to investors, it should be noted that, like any investment, opportunity zones come with risks, including illiquidity for 10 years, loss of principal, real estate risks, and more. Additionally, the IRS and Treasury are still in the process of determining how to implement these rules and they may change over time. Sponsors and investors should consult with a tax specialist before pursuing a qualified opportunity zone fund.

2018 tax reform laws have created a new investment category: Opportunity Zones. Qualified Opportunity Funds join an increasingly popular group of tax-advantaged investments, such as 1031 Exchanges, that allow investors to defer or avoid capital gains taxes on the sale of certain investment properties. But there

are some key similarities and differences between 1031 Exchanges and Opportunity Zones that advisors should know about before recommending them to clients.

What are the similarities?

The tax benefits of Section 1031 Exchanges and investments in Qualified Opportunity Funds have many similarities. Both 1031 Exchanges and Opportunity Zones:

- Allow investors to defer recognizing the gain on the sale of an investment or property. This is one of the main reasons 1031 Exchanges have historically been so popular.
- Encourage investors to reinvest their gains from previous investments, which helps keep money in the real estate market, encouraging growth.
- Mostly feature investments into real estate; a market that has a low correlation to the wider market.

What are the differences?

Despite the similarities between 1031 Exchanges and investments into Qualified Opportunity Funds, there are also significant differences in both their tax treatment and rules around where gains may come from.

Tax

One major difference between taking advantage of a 1031 Exchange and investing into an Opportunity Zone is how long the investor's gain is deferred. For a 1031 Exchange, the investor may defer the tax on the gain from the sale of the previous property until the sale of the replacement property. If the investor decides to once again roll their entire investment into yet another eligible property, gains continue to be deferred until a property is finally sold.

For a Qualified Opportunity Fund, the investor may defer the tax on the gain from the sale of the previous property until either of the sale of the property or December 21, 2026, whichever comes first. As a result, investors in a 1031 exchange may be able to defer recognition of their gain for a longer period than investors in a Qualified Opportunity Fund if the 1031 property is still held after December 21, 2026.

Participation in a 1031 Exchange allows an investor to defer recognizing their gains from the sale of a property for a time. However, when a property is eventually sold for cash, the investor will have to recognize the full extent of their capital gain. For investors in a Qualified Opportunity Fund, they not only get to defer their gain, but if they hold the investment long enough, they may receive exclusions on a percentage of their gain. For example, if an investor in a Qualified Opportunity Fund holds her investment for more than 5 years, then, when that gain is recognized, the investor may exclude 10% of the gain. This means that they would only pay tax on the other 90% of their gain on the sale of the original property. If the investor holds for 7 years then this exclusion jumps to 15%. A full list of FAQs relating to Opportunity Zones can be found on the IRS website.

Perhaps the largest difference between the tax benefits of participating in a 1031 Exchange and investing in a Qualified Opportunity Fund is the stepped-up basis on the investment into a Qualified Opportunity Fund if the investor holds it for more than 10 years. This means that when the investor sells an investment in the Qualified Opportunity Fund, basis (the amount of the original investment) is increased to the fair market value at the time of the sale. Since taxpayers are taxed on the difference between their basis and the sale price, this effectively means the transaction will be tax free. In a 1031 Exchange, the original basis follows the investor through the exchange and is used when the replacement property is finally sold, at which time the investor pays the tax on the difference between their basis in the original property and the sale amount of the replacement property. The stepped-up basis for investments into a Qualified Opportunity Fund is a huge benefit for investors who are able to hold an investment for that long.

Property

1031 Exchanges and Opportunity Zones also differ on the types of property into which an investment can be made. For a 1031 Exchange, the IRS requires the replacement property to be of a “like-kind” to the property the taxpayer sold. The IRS defines “like-kind” as “property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate.” Additionally, the property must be used for a trade or business or for investment. This means that any commercial real estate likely qualifies for a 1031 Exchange. Qualified Opportunity Funds must invest in Opportunity Zones, define by the census tract location, which consist of designated distressed communities around the country. Thus, only property in these zones qualifies for investment for a

Qualified Opportunity Fund, unlike any commercial real estate for a 1031 Exchange. Considering the large number of Opportunity Zones, this may not be a huge hindrance for investors.

Investments into Qualified Opportunity Funds and 1031 Exchanges also differ on where the invested capital originated. While investments in a 1031 Exchange must follow the “like-kind” rule, investments into Qualified Opportunity Funds may come from the sale of any investment property, whether real estate or investments in the stock market. With the tax benefits of investing in Qualified Opportunity Funds, this is a boon for investors.

1031 Exchanges and investments in Qualified Opportunity Funds are both enticing opportunities for investors, but, despite their similarities, the differences between these two investment opportunities require potential investors to thoroughly review their options prior to making an investment.