Opportunity Zone program vs. a 1031 exchange: Understanding the risks and benefits of each - by Michael Packman

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There’s been a lot of buzz lately around Opportunity Zones and the qualified funds that must be set up in order to invest in them. The Opportunity Zone program was created by the Tax Cuts and Jobs Act of 2017. An investor who contributes capital into a Qualified Opportunity Fund that deploys capital into a Qualified Opportunity Zone as acknowledged by this act is provided certain tax incentives. The program was designed to encourage investors to commit capital for the long term to disadvantaged communities across the nation. Opportunity Zones have been designated in every U.S. state, Puerto Rico, and the Virgin Islands.

I get asked all of the time lately if someone should invest in an Opportunity Zone Fund instead of doing a 1031 exchange and what the differences are. So, I’m going to make a quick comparison here which will also give some of the basics on Opportunity Zones. From a financial perspective, the biggest difference is that you only need to reinvest the gain, not the entire proceeds, in an Opportunity Zone Fund, whereas in a 1031 you need to reinvest the entire proceeds. While you only need to invest the gain, you do have to follow some additional rules. According to the statute, the property must have been acquired by purchase (not exchange) after December 31st, 2017 and also meet a couple of other qualifications. A property in which its original use in the Opportunity Zone commences with the Qualified Opportunity Zone business, or such property is substantially improved over a 30-month period; and a property which is substantially used (e.g. available to be leased) during substantially all of the Qualified Opportunity Zone business’ holding period in the opportunity zone.

An investment in an Opportunity Zone doesn’t need to be like-kind, whereas in an exchange, the replacement property must be. You do need to close on the replacement in both cases within 180 days; however, for an Opportunity Zone investment, you don’t need to identify the property within 45 days or use an intermediary, like in an exchange. Not having to rush to identify properties within in 45 days, filing additional paperwork by certain deadlines and making sure all money is held in escrow correctly for the entire 180 days, can definitely simplify the process.

When selling the property, there are some major differences. First of all, an exchange can continually be deferred as long as you continue to do exchanges, however if you sell and don’t do an exchange, you will recognize 100% of the gain. The exception to this would be if you were to pass away, your heirs do get a stepped-up basis to the current market value. For an investment in an Opportunity Zone, you get a stepped-up basis of 10% if your interest in the fund is sold after five years and 15% if sold after seven years. However, any gains earned in the fund are tax free if the investment is held for 10 years or more. One disadvantage to Opportunity Zone Fund investments, as of now, is that the taxes must be paid by 2026, even if the fund interest hasn’t been sold. There is talk of this being extended, but the adjustment hasn’t been made as of yet.

Current investments that qualify for Opportunity Zone Funds include commercial real estate development or renovation, opening new businesses, expansion of businesses into Opportunity

Zones, or the continued expansion of a business already located inside one. This allows for much more flexibility than a 1031 exchange, but also the potential for more risk and more complication. Another major factor is the experience of the managers of these funds. It is very important to do your due diligence before investing with anyone and to make sure their model makes sense to you. Which direction to go can be a big decision, especially if the gain being invested is a significant portion of your net worth. My advice is to evaluate both routes and make sure you fully understand the risks and potential benefits of both of the options. If you decide to invest in an Opportunity Zone Fund, make sure you know who you are getting involved with and are comfortable with their strategy.

Amy Kelly, COO of Sixty West Funds contributed to this article.

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