



The Wizard of OZ (that's "Opportunity Zones"): OZ vs. 1031, Part 1 - by Dan Flanigan

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OZ vs. 1031: Part 1

You are about to sell a capital asset and trying to figure out whether a 1031 exchange or an Opportunity Zone (OZ) investment is the right way to go.¹ That depends on a variety of circumstances special to your situation, status, and goals. The devil (and the angel too) is in the details. Here are some things to consider.

Sellers of Personal Property Need Not Apply (for 1031)

We'll start with the easiest one. If the capital asset you are about to sell is not real estate, there is nothing to think about. The 1031 exchange option is available only to owners of real estate. Only the OZ program offers sellers of such items as stock, partnership interests, art, stamp collections, etc. the possibility of special favorable treatment of capital gains.

All or None in 1031

Do you own the real estate directly or in a partnership or llc? If the latter, unless the entity governance documents clearly provide otherwise, all of the owners of the partnership or llc must agree to enter into an exchange transaction. If some of the partners or llc members want to cash out (perhaps to invest in an OZ fund), those who want to exchange cannot do so without engaging in some complicated and risky acrobatics called a "Drop & Swap" (and even that requires a degree of cooperation from the other partners or members).

On the other hand, subject to contrary provisions in the entity governance documents, each of the partners or llc members may separately elect to reinvest their proceeds in an OZ Fund, leaving the others to direct their proceeds elsewhere.

Moreover, the gross purchase price of the replacement property must equal or exceed the gross sales price of the relinquished property, and your total equity must continue to be invested in the new property. All of your proceeds including proceeds used to pay off debt on the property you are exchanging (including "virtual" payoff in the form of assumption of debt) must be invested in the replacement property. If you come up short on any of this, you will not get a complete deferral but you will be charged with "boot," and some or all of your tax will be due depending on the amount of boot.

If you invest in a Qualified Opportunity Zone Business (QOZB) through a Qualified Opportunity Fund (QOF), you do not need to invest all of your proceeds to obtain the full benefit of the program. Rather, you are only required to invest the amount of your capital gain and you can pocket that part of the sale proceeds that constitutes a return of your invested capital to use for other purposes. However, any portion of capital gain you choose not to invest, like boot in a 1031, will not obtain the deferral benefit and thus will be taxed currently.

Deferral Of Gain Incurrence

1031 provides for a deferral of gain until the sale of the property for cash, an event that normally will provide sufficient funds to pay your taxes, but more importantly, potentially permits you to continue the deferral forever if you can keep exchanging until you die, a strategy humorously called, "Swap 'Til You Drop."

The OZ program provides for a deferral of gain until the earlier of disposition of your OZ investment or December 31, 2026. The mismatch between this date, a maximum of six-plus years as of this writing, and the required holding period of 10 years to obtain the most valuable OZ benefit creates a potential "liquidity" issue for the investor who must pay tax on the gain but the invested proceeds are "frozen" in the OZ investment.

I believe this "liquidity" problem is exaggerated. I am inclined to say to the hand-wringers, "Get a life!" You likely have several years to plan smartly between the date of the investment and December 31, 2026. Note too, that the OZ regulations allow you to borrow against your interest in the Fund, and there will likely be debt funding sources available when the tax must be paid, at least for successful investments. Even if the investment is not so successful, another benefit of OZ is that the tax assessed as of December 31, 2026 is based on the lesser of fair market value or the deferred amount, allowing unsuccessful ventures and their investors to reduce or eliminate the tax owed in 2026. Most obviously and simply, you can "put away" in a safe place enough proceeds from your gain transaction to cover the taxes that you will have to pay in 2026 and earn some interest in the meantime.

Exemption From Tax On Current Gain

If you stop 1031 exchanging before you die, you incur the gain and must pay the tax on that gain. But if you hold on to the property acquired in the exchange or keep successfully exchanging until you die, your heirs receive a stepped-up basis in the asset based on its fair market value at the time of your death, thus relieving you and them entirely from tax on all of the unrealized gain built up over the years.

OZ provides a possible 15% exemption from tax, a much inferior benefit, but you don't have to die to achieve it. You receive a 10% exemption from your ultimate capital gain if you own the OZ investment for a period of five years before December 31, 2026, which requires an OZ investment to be made by December 31, 2021. You receive an additional 5% exemption from tax if you own the

OZ investment for a period of seven years before December 31, 2026, which requires an investment to be made by December 31, 2019.

Forgiveness Of Tax On Gain From New Investment

If you hold the OZ investment for 10 years, the additional gain achieved during the OZ holding period on the investment is tax free. The 1031 “Swap ’Til You Drop” achieves the same result by a different method (the stepped-up basis upon death described above), but if you falter in this giddy march toward oblivion and dispose of your property in other than a 1031 exchange along the way (think financial reversals, health problems, and other unfortunate occurrences), you incur the full tax at that time on the original gain and all the appreciation in value not covered by your basis in the property.

To be continued in Part 2 . . .

1 As usual with these columns, this column assumes readers’ knowledge of the basic OZ statutory provisions; for a summary of the basic provisions, see Polsinelli.com/intelligence/oz-ppt.

Dan Flanigan is Managing Partner of the New York Office of POLSINELLI, an AmLaw 100 firm with offices in 22 major U.S. cities. DFLANIGAN@POLSINELLI.COM

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