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Opportunity Zones: A useful backup plan for 1031 exchanges - by Daniel Pessar

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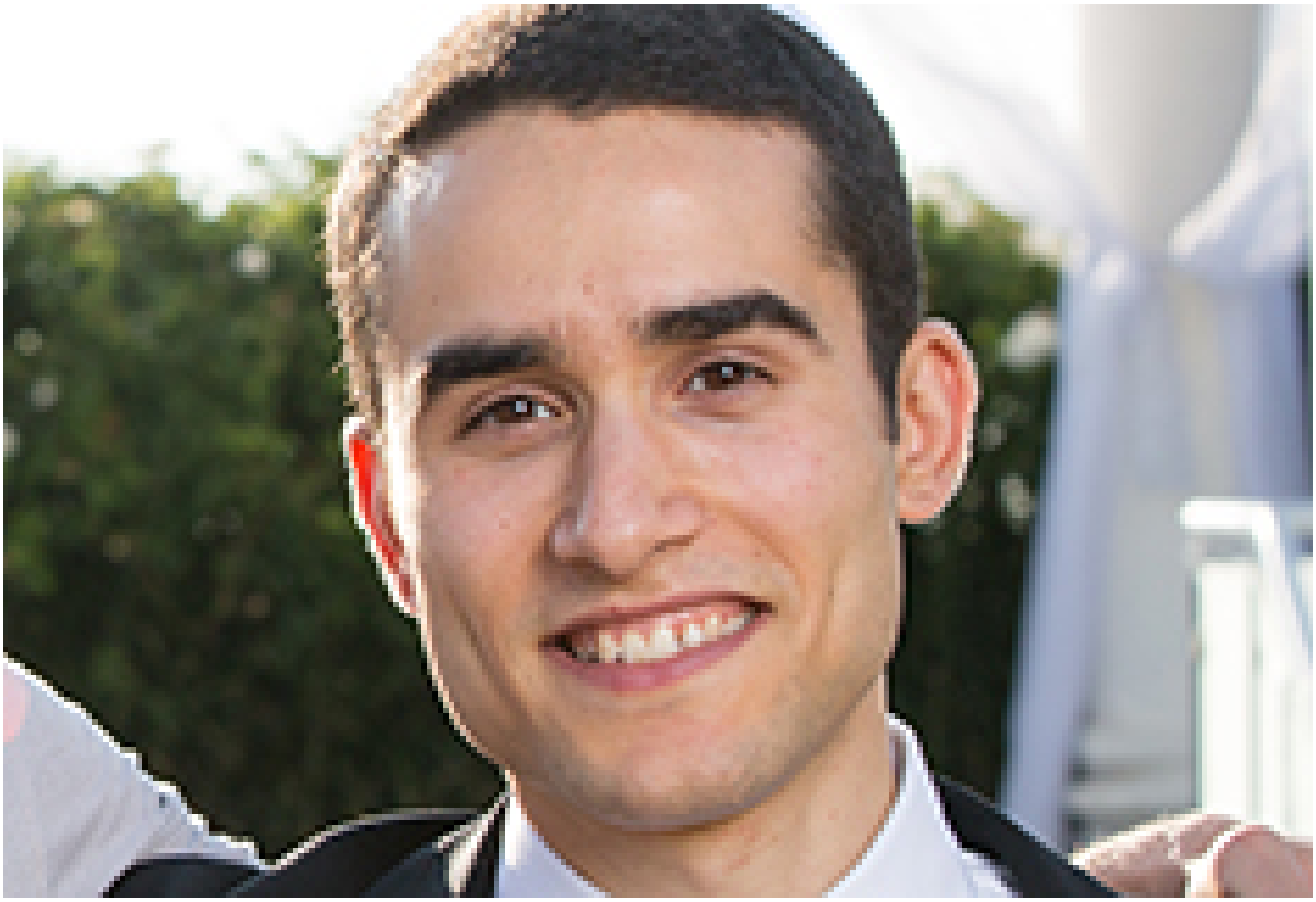

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When real estate investors sell property, they often defer any capital gains using the like-kind, tax deferred exchange, provided for in Internal Revenue Code Section 1031. As explained in the tax regulations:

[A] deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for productive use in a trade or business or for investment (the “replacement property”).1

Although this provision was long available for use with a broad array of property types, since the 2017 Tax Cuts and Jobs Act, it is only available for real estate.2

To qualify for nonrecognition of gain or loss under Section 1031, a taxpayer must follow quite a few rules, including many time-sensitive requirements. For example, a taxpayer must identify replacement property within 45 days of transferring the relinquished property,3 and receive the replacement property within 180 days of transferring the relinquished property.4

The regulations allow replacement properties to be identified in three ways:

Three properties can be identified, without regard to the value of the properties; 5

Any number of properties can be identified as long as their value does not exceed 200% of the value of the relinquished properties;6 or

Any number of properties can be identified as long as the exchanger receives, before the end of the exchange period, 95% of those properties, measured by fair market value.7

The taxpayer is not required to defer all of the capital gains, however. It is possible to defer part of the gains by receiving qualified replacement property in addition to nonqualified property, triggering capital gains taxes on a part of the sale and deferring taxes on another part of the sale.8

But finding satisfactory investment property before the end of the 45-day identification period, and then completing the negotiation, due diligence and closing within the 180-day exchange period, is no simple task. Sophisticated operators often negotiate replacement property acquisitions even before relinquished properties are marketed for sale to ensure satisfactory replacement property is available for a tax-deferred exchange.

Sometimes, this means paying a higher price for a property in order to receive a longer closing window. As well, firms sometimes agree to accept a lower price on relinquished property in exchange for a longer closing window on disposition.

Firms are also able to close on replacement property purchase transactions before closing on relinquished property sale transactions using a so-called reverse exchange transaction. Both the reverse exchange and forward exchange are facilitated by a qualified intermediary which serves as the middleman between the taxpayer and both the seller of the replacement property and the buyer of the relinquished property.

Even though the taxpayer does not appear to exchange the relinquished property for the replacement property—it would be very hard to find two taxpayers each willing to exchange property with each other—the law treats a taxpayer using a qualified intermediary as having properly exchanged relinquished property for replacement property.

After the identification period, however, the replacement property acquisitions may not materialize. Negotiations do not always succeed, sellers cannot always deliver the property on time and concerns are sometimes discovered during due diligence that make a deal impossible.

Moreover, if the 95% rule identification method is the one chosen by the taxpayer, several acquisitions would need to close successfully before the end of the exchange period in order for any tax deferral to occur. For example, if a taxpayer identified 20 properties each worth $10, unless 19 or more of the properties are received by the taxpayer before the end of the exchange period, the taxpayer is not able to defer any gain.9

Although transactions can sometimes be scuttled at the last minute, taxpayers might have indications weeks or months before the end of the exchange period that the transactions might not happen on time, if at all.

While the realization that anticipated tax deferral is unlikely to materialize might cause a good deal of hand wringing, investors now have a potential backup plan in the Qualified Opportunity Zone (QOZ) legislation.

QOZ investments must be made within 180 days after capital gains are generated but there is no earlier identification period. As well, the 180 days marks the due date for investing a QOF, something that can occur before underlying property to be purchased or developed by the fund is even identified.

Without incurring any penalties, a QOF could wait to close on a development site for up to six months after being funded, giving the taxpayer additional time to identify property.10 Thus, a taxpayer who realizes 90 days after selling property that the Section 1031 exchange will not be successful, could fund a QOF approximately 90 days later, and the QOF would not need to close on replacement property for up to just under six months thereafter without penalty.11

Moreover, while no deferral is available if a taxpayer does not strictly follow the tax-deferred exchange timeline, there is more flexibility in the QOZ rules. For example, a taxpayer who has funded a QOF but takes a year to find a suitable investment will see a relatively small penalty—currently 5% per year multiplied by the amount of capital that was supposed to have been invested in qualifying property but was not.12

While penalties are not welcomed by any taxpayer, this outcome might be more acceptable than a total lack of tax deferral, or settling for unsatisfactory replacement property.

There are limits, however, to thinking about opportunity zone investments as a proper alternative. Firstly, while tax-deferred exchanges can provide decades of tax deferral,13 opportunity zone investments only allow deferral until Dec. 31, 2026.14

Second, a taxpayer interested in receiving the tax benefits offered by the opportunity zone laws must hold onto the equity for at least 10 years.15 Although the regulations clearly allow QOF interests to be sold and replaced with others without forfeiting the tax benefits,16 QOF interests are not as easy to buy and sell, compared to standard real estate equity interests that are bought and sold daily inside and outside of tax-deferred exchange transactions. This reality is driven by the fact that the market for QOZ interests is tiny compared to the broader market for real estate equity interests.

Finally, opportunity zone investments have important reporting requirements and other rules that are unfamiliar to most real estate investors. While learning about the rules and evaluating the suitability of QOF investments for the investor's portfolio is certainly possible after a failed like-kind exchange and before the 180 days run out, it can be difficult and stressful.

This is especially true if the investor is less familiar with the development-style investments which match QOF investment requirements. Simple buy-and-hold real estate, like the kind often purchased in a tax-deferred exchange, rarely satisfies the QOZ tax rules.

Of course, the most reliable way to ensure post-sale tax deferral over the long term is by going into contract on replacement properties (or even acquiring them with the help of a qualified intermediary) before selling the relinquished property. But this is not always possible for all investors, and the rushed effort to identify and close on acceptable replacement properties is not always successful.

In those situations, being familiar with specific assets in QOZ neighborhoods, with certain developers doing projects in QOZs, or even with the rules involved in establishing and managing a QOF can prove useful. If the Section 1031 exchange does not work out, QOZ investments may offer an acceptable alternative.

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1 Treas. Reg. Section 1.1031(k)-1(a)
2 See IRC Section?1031(a)(1)
3 Treas. Reg. Section 1.1031(k)-1(b)(2)(i)
4 Treas. Reg. Section 1.1031(k)-1(b)(2)(ii)
5 Treas. Reg. Section 1.1031(k)-1(c)(4)(i)(A)
6 Treas. Reg. Section 1.1031(k)-1(c)(4)(i)(B)
7 Treas. Reg. Section 1.1031(k)-1(c)(4)(ii)(B)
8 See 1.1031(k)-1(j)(3)(Example 1)
9 See Treas. Reg. Section 1.1031(k)-1(c)(4)(ii)(B)
10 See Form 8996 (Rev. 1-2020), Part II
11 See Form 8996 (Rev. 1-2020), Part II
12 See IRC Section?1400Z–2(f)
13 Like-kind exchanges can also facilitate indefinite tax deferral when capital gains taxes are deferred until an investor's assets passes to inheritors and the taxpayers benefit from a Section

1014 step up of basis at death
14 See IRC Section?1400Z–2(b)
15 See IRC Section?1400Z–2(c)
16 See IRC Section 1.1400Z2(a)-1(b)(7)(iv)(D)(1)(Example 4)