Opportunity Zones & 1031 Exchanges

What Qualifies and What Does Not Qualify

1031 Knowledge

SECTION 1031

The tax code incentivizes investors to allocate capital in ways which achieve desired social outcomes. Internal Revenue Code Section 1031 helps businesses expand into more space and increase the capacity of investment properties. Section 1031 exchanges add to the supply of housing units, increase industrial capacity, upgrade properties into more energy efficient offices, and increase the supply of real property held for investment or used in a business.

SECTION 1400Z-1, 1400Z-2

A new tax code section, IRC §1400, more commonly known as the Opportunity Zone (OZ) provision, provides tax incentives on deferred gains along with the potential for tax exclusion on new gains for assets held at least 10 years. Tax advantages are available to investors who allocate capital to a designated OZ by investing in an Opportunity Zone Fund (OZ Fund) in economically depressed areas. The areas have been identified for targeted tax benefits to attract new capital with the goal of revitalizing these low-income communities.

There are three federal income tax benefits for investors. (1) Temporary deferral of taxes on rolled over gains (owed at the end of 2026.) (2) Deferred gains invested in an OZ Fund that are held for five years qualify for a 10% reduction of the deferred gain. Deferred gains held for another two years, for a total of seven years, receive a 15% reduction in the deferred gain. At the end of 2026, capital gain taxes are due on the remaining 85% of the deferred gain. Unlike a 1031 exchange, OZ Funds do not allow permanent capital gain deferral. (3) Investors who choose to invest in an OZ Fund and hold for 10 years receive 100% tax exclusion on any new gain within the OZ Fund investment. There are three possible ways investors can take advantage of OZ investments in conjunction with 1031 exchanges along with two approaches that will generally not qualify.

WHAT WORKS?

1. 1031 Exchange into an Opportunity Zone: Fallback Approach

The 1031 exchange requirements and OZ rules are separate provisions and investors must adhere to the rules for each tax code provision independently. However, an OZ can be a fallback strategy for 1031 exchange investors. Here is how this can work: An investor initiates a 1031 exchange and does not find suitable replacement property within 45 days or changes their mind within 45 days and decides to invest money into an OZ instead of like-kind real property in a 1031 exchange. The investor notifies the qualified intermediary (QI) that they haven't identified any replacement property and want to receive their 1031 exchange proceeds on day 46. The QI releases the exchange proceeds to the investor on day 46. Now, the investor has 135 more days (up to 180 days from the sale of relinquished property) to invest proceeds into an OZ Fund. A significant benefit of changing strategies from a 1031 exchange to OZ is that the investor only needs to invest the gain into an OZ Fund (not all net proceeds and equal or greater debt like needed for full tax deferral in a 1031 exchange.)

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2. 1031 Exchange and OZ Combined: OZ Investment Added to 1031 Exchange Replacement Property

First, the exchanging entity (which must be a regarded entity like partnership or corporation, not a disregarded entity for federal tax purposes) completes a 1031 exchange into a qualifying like-kind replacement property. Next, after the 1031 exchange is complete, the entity elects for OZ Fund status. Afterward, new OZ Funds from other sources or from syndicated funds are used to substantially improve the 1031 replacement property. As a result, the gain in the 1031 exchange is deferred past 2026 (until the entity sells in a later taxable sale) and separately the gain deferred in the OZ Fund used for improvements qualifies for favorable OZ tax treatment.

3. 1031 Exchange or Opportunity Zone (or Both)

When an investor sells a relinquished property held for investment, they have three options involving 1031 exchanges and OZs. A) Initiate a 1031 exchange and obtain tax deferral under the 1031 exchange rules and requirements. B) Invest the capital gain into an OZ Fund pursuant to the OZ rules and requirements. C) Take advantage of both tax strategies and split the exchange proceeds, allocating some funds to a 1031 exchange and investing the remaining proceeds into an OZ Fund. Using this third combined 1031 exchange and OZ strategy, the basis of the relinquished property should be split pro rata with some gains attributed to the 1031 exchange and some gains to the OZ Fund.

WHAT DOES NOT WORK

1. An investor cannot do a 1031 exchange into an OZ Fund as replacement property. The OZ Fund is a fund, and not qualifying like-kind real property. Only real property held for investment or used in a business qualifies for 1031 exchange tax deferral.

2. An investor cannot generally initiate a 1031 exchange, identify property in 45 days, and not purchase all the identified property and then decide to later invest remaining exchange proceeds into an OZ Fund after the expiration of the 180-day Exchange Period. Section 1.1031 (k)-(g)(6) specifies an investor must acquire all replacement property they are entitled to (i.e. all property identified within the Identification Period) or wait until day 181 (the expiration of the Exchange Period) to receive 1031 exchange proceeds from the QI. If an investor receives proceeds from the QI on day 181, they are generally outside the 180-day reinvestment time required by OZ rules and not eligible to invest into an OZ Fund. There is a narrow exception for certain investors who have Section 1231 gain, which is gain from the sale of assets used in a business for more than one year. Section 1231 gains and losses must be netted at the end of the tax year so the 180-day period for Section 1231 gain being invested in an OZ fund may begin on the last day of the taxable year in some situations.

The rules and tax benefits around OZ Funds are complex and continue to evolve as the U.S. Treasury releases new regulations. Every investor should seek the advice of tax advisors to review their specific transaction.

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