

# **An Overview of Opportunity Zones (OZ) and a Comparison of the Pros and Cons Of Opportunity Zones versus 1031 Exchanges**

Presented by

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# Disclaimer

- ▶ This presentation is intended to be a general overview of Opportunity Zone (OZ) investments.
- ▶ Opportunity Zone legislation is new and full of considerable uncertainty and unanswered questions.
- ▶ The tax related information contained herein should not be construed as tax or legal advice specific to your situation and should not be relied upon in making any business, legal or tax related decision. A proper evaluation of the benefits and risks associated with a particular transaction often requires advice from a competent tax and/or legal advisor familiar with your specific transaction, objectives and the relevant facts. We strongly urge you to involve your tax and/or legal advisor in any significant real estate or business related transaction.

# Instructor: Scott R. Saunders

- ▶ Sr. Vice President of Asset Preservation, Inc. (API)
- ▶ API, a Stewart subsidiary, a leading national qualified intermediary (QI) has facilitated over 180,000 exchanges
- ▶ 31+ years of experience with 1031 exchanges
- ▶ Over 180+ articles on exchanges/investment real estate
- ▶ Quoted in the Wall Street Journal, CNBC, Forbes, U. S. News and World Report
- ▶ CE Instructor for many trade organizations
- ▶ President-Elect for the Federation of Exchange Accommodators, the national 1031 exchange industry trade organization (1031.org)

# Outline

- ▶ Overview of Opportunity Zones (OZ)
- ▶ Intent of Opportunity Zones
- ▶ Opportunity Zone Legislative History
- ▶ Opportunity Zone Price Appreciation April, 2018 to Present
- ▶ Opportunity Zone Terminology
- ▶ Qualified Opportunity Zone
- ▶ Qualified Opportunity Fund
- ▶ Three Opportunity Zone Fund Requirements
- ▶ Three Levels of Opportunity Zone Tax Benefits (2 Deferral, 1 Exclusion)
- ▶ Section 1031 Exchange Legislative History
- ▶ “1031 into OZ” Strategy: What Works & What Doesn’t
- ▶ Comparison: Opportunity Zone versus 1031 Exchange
- ▶ Summary: Tax Advantages of Selling Real Property in a 1031 Exchange
- ▶ Contact Asset Preservation

# 30,000 Foot Overview of Taxes

- ▶ Tax policy is a tool government uses to implement social policy.
- ▶ Tax code incentives are areas where government wants to see more economic activity and investment of resources.
- ▶ For example, the government encourages home ownership by providing tax incentives like the Mortgage Interest Deduction (MID) during home ownership and tax exclusion upon sale pursuant to Section 121 up to the \$250,000/\$500,000 thresholds.
- ▶ Charitable tax deductions encourage contributions to charities.
- ▶ Section 1031 exchanges encourage investment into business property. Section 1031 also fosters the creation of more real estate for businesses and a growing stock of real estate and increasing national housing supply.

# 30,000 Foot Overview of OZ

- ▶ A significant new tax incentive
- ▶ Applies to any investor with capital gains
- ▶ Must fund new business and/or development
- ▶ Only applies to new investments made into a Qualified Opportunity Zone
- ▶ IRC Section 1400Z-1 and 1400Z-2 added to the tax code
- ▶ U.S. Treasury has released Proposed Treasury Regulations clarifying many (but not all) aspects of Opportunity Zone investments.

# And OZ is not...

The land of OZ



# OZ is more like...

A potentially excellent investment opportunity to boost ROI



# The Intent of OZ

- ▶ 1 out of every 6 U.S. citizens live in economically distressed communities.
- ▶ Congress wanted to try to accelerate the redistribution of wealth:
  - Across Geography: From affluent areas to low-income locations;
  - Across Asset Sectors: Stock market to real estate.
- ▶ Under the TCJA, states could nominate communities they want to be designated as a Qualified Opportunity Zone to encourage economic revitalization. A Qualified Opportunity Zone retains this designation for ten (10) years.

# The Intent of OZ

- ▶ Promote economic growth in areas not sharing in the general increase in prosperity.
- ▶ Help fund the development of affordable housing.
- ▶ Invest in start-up businesses that rapidly grow and scale.
- ▶ Upgrade underutilized assets through capital improvement investments.

# Intent of OZ and the Numbers



# 35,000,000

Number of people who live in an opportunity zone

According to Ben Carson, Chair of the White House Opportunity and Revitalization Council, “...almost 10% of the country’s population will now have a pathway to financial success due to the single stroke of a pen.”

# Intent of OZ and the Numbers

\$6.1

Trillion  
dollars in  
unrealized  
capital  
gains

\$2.3

Trillion  
businesses

\$3.8

Trillion  
individuals

OZ are the approach to redistribute trillions into real estate in areas of the U.S. that are distressed or underperforming economically.

# Legislative History - OZ

- ▶ Originally developed in 2015
- ▶ The program is based on the “Investing in Opportunity Act”
- ▶ In late 2017, the program was adopted under the Tax Cuts and Jobs Act (TCJA.)
- ▶ TCJA created a new investment vehicle called an Opportunity Zone (OZ) to encourage investment into distressed and low-income communities throughout the United States.
- ▶ No more investments allowed into Opportunity Zone after the end of 2021.

# OZ Property Values: April 2018+

- ▶ Since April, 2018, sale prices on property in OZ's have risen by 20% according to a Zillow study reported in the World Property Journal.
- ▶ Ineligible tracts of land saw slower appreciation.
- ▶ 5 of the 10 most attractive OZ's are within New York City, NY and include an OZ in Brooklyn Heights, other OZ's in Brooklyn and Queens neighborhood of Astoria.
- ▶ Other top OZ's include Wayne State University area of Detroit, historic Waverly Place in Nashville, TN and Charlestown neighborhood in Boston, MA.

# Qualified Opportunity Zone

- ▶ These are specific tracts of land nominated by state governors and certified by the U.S. Treasury Department.
- ▶ The land nominated had to meet some “low-income community” requirement standards.
- ▶ However, governors had the flexibility to expand into developed or already developed areas.
- ▶ All OZ’s have already been determined.

# Qualified Opportunity Zone



**9,000**

Approximate number of opportunity zones nationwide

A list and complete map of all Opportunity Zones can be found on the U.S. Treasury Department's Community Development Financial Institutions Fund (CDFI) website: [cdfifund.gov/Pages/default.aspx](http://cdfifund.gov/Pages/default.aspx)

# Technical OZ Terminology

**QOZ** =  
Qualified  
Opportunity  
Zone

- Land areas designated to benefit from the OZ program.

**QOF** =  
Qualified  
Opportunity  
Fund

- The investment vehicle used to obtain the tax benefits.

**QOZBP** =  
Qualified  
Opportunity  
Zone Business  
Property

- The actual investment needed to qualify for tax benefits.

# Preferred Terminology

**OZ**

- Qualified Opportunity Zone

**OZ Fund**

- Qualified Opportunity Fund

**OZ Investment**

- The investments inside an OZ Fund that taxpayers invest in to qualify for the tax benefits. More specifically, equity investments into businesses and property in an OZ. (QOZBP)

# Opportunity Zone Fund

- ▶ The tax incentive is designed around a new investment opportunity, an OZ Fund in this presentation.
- ▶ Investors can obtain tax benefits if:
  - They have eligible capital gains that less than 180 days old.
  - Purchase an OZ Fund equity interest with cash.
  - Must file an additional form with personal tax return.
- ▶ The OZ Fund:
  - Find and invest in qualifying OZ investments.
  - Certify compliance to the IRS.
  - Pay penalties for non-compliance.

# Three OZ Fund Requirements

1. Must be a corporation or partnership for federal income tax purposes.
  - C-Corps, LP's, LLC's taxed as corporations, LLC's taxes as partnerships all qualify. LLCs that are disregarded for federal tax purposes do not qualify as the entity must be a regarded entity.
2. Must be in the United States
3. Must be at least 90% invested in OZ businesses or property (referred to as OZ Investments).

# Certification of OZ Funds

- ▶ The Statute authorizes a regulatory process for the certification of OZ Funds by the U.S. Treasury.
- ▶ The U.S. Treasury has announced OZ Funds will self-certify by filing a form with their tax return.
- ▶ There is no limit on the number of OZ Funds that can be created.

# OZ Investments

The OZ Fund must invest at least 90% of total assets into OZ Investments.

These investments should be:

- ▶ Tangible property
- ▶ Purchased after January 1, 2018
- ▶ Purchased new or substantially improved
- ▶ Used in a trade or business
- ▶ Used mostly within an OZ

# What is Tangible Property?

In general, tangible property is anything you can touch:

Land (with qualifications)

Leased Property (with qualifications)

Manufacturing equipment

Buildings and structures

Office equipment and furnishings

Tangible property is generally not:

Cash

Financial investments

Intellectual property

# 90% OZ Fund Requirement

- ▶ 90% of the OZ Fund's total assets must be qualified OZ investments.
- ▶ Tested twice annually at fiscal 6-month end and fiscal year-end.
- ▶ If the average of the 6 month and year-end tests results in less than the 90% threshold, then the OZ Fund faces penalties and possible disqualification.

# Qualified and Non-Qualified Investors

Two types of investors can invest in a OZ Fund:

1. Qualified investors (rolling over deferred capital gains)
  2. Non-qualified investors (ordinary investment)
- ▶ OZ Funds can have qualified and non-qualified investors.
  - ▶ Individual investors can also invest both qualified and non-qualified interests into an OZ Fund.

# Three Levels of OZ Tax Benefits

- ▶ OZ investments provide tiered capital gain tax benefits at the following time periods:
- ▶ Five (5) year time frame
- ▶ Seven (7) year time frame
- ▶ Ten (10) year time frame
- ▶ Temporary deferral of capital gain taxes on deferred gains invested in an OZ Fund until the taxpayer exits the OZ Fund or December 31, 2026, whichever occurs first.

# Three Levels of OZ Tax Benefits

- ▶ Deferred capital gains resulting from investments in the OZ Fund held a minimum of five (5) years are given 10% reduction in the amount taxed.
- ▶ Investments held in the OZ Fund at least seven (7) years are given a 15% reduction in the amount taxed.
- ▶ If a taxpayer holds an investment for ten (10) years, the new capital gains accrued on the OZ Fund investment (i.e. the property profit) will receive a full step-up in basis after the ten-year period.
- ▶ This final benefit results in tax exclusion and is a permanent exclusion of taxable income for investments into an OZ Fund.

# New OZ Guidance: April 17, 2019

- ▶ On April 17, 2019, the Treasury released proposed regulations addressing issues related to OZ investments. These included:
- ▶ OZ Funds will receive additional leeway to invest capital on a more flexible timeline.
- ▶ OZ Funds will be able to include more than one investment in a OZ Fund providing additional diversification.
- ▶ OZ investors will be eligible for preferential tax treatment as long as they hold their OZ Fund investment for at least 10 years even if the OZ Fund did not hold the asset for the full 10 years.
- ▶ Working capital can be used for development of an operating business, not just a real estate development.
- ▶ Greater flexibility on the requirement that businesses generate at least 50% of gross income within the OZ.

# OZ Investment Timeline

Year 1: 2019, roll gain into an OZ Fund.

2019

Year 5: 2024, 10% reduction in tax on original deferred gain.

2024

Year 7: 2026, investor receives an additional 5% reduction on original deferred gain (for a total of 15% deferred gain reduction.)

2026

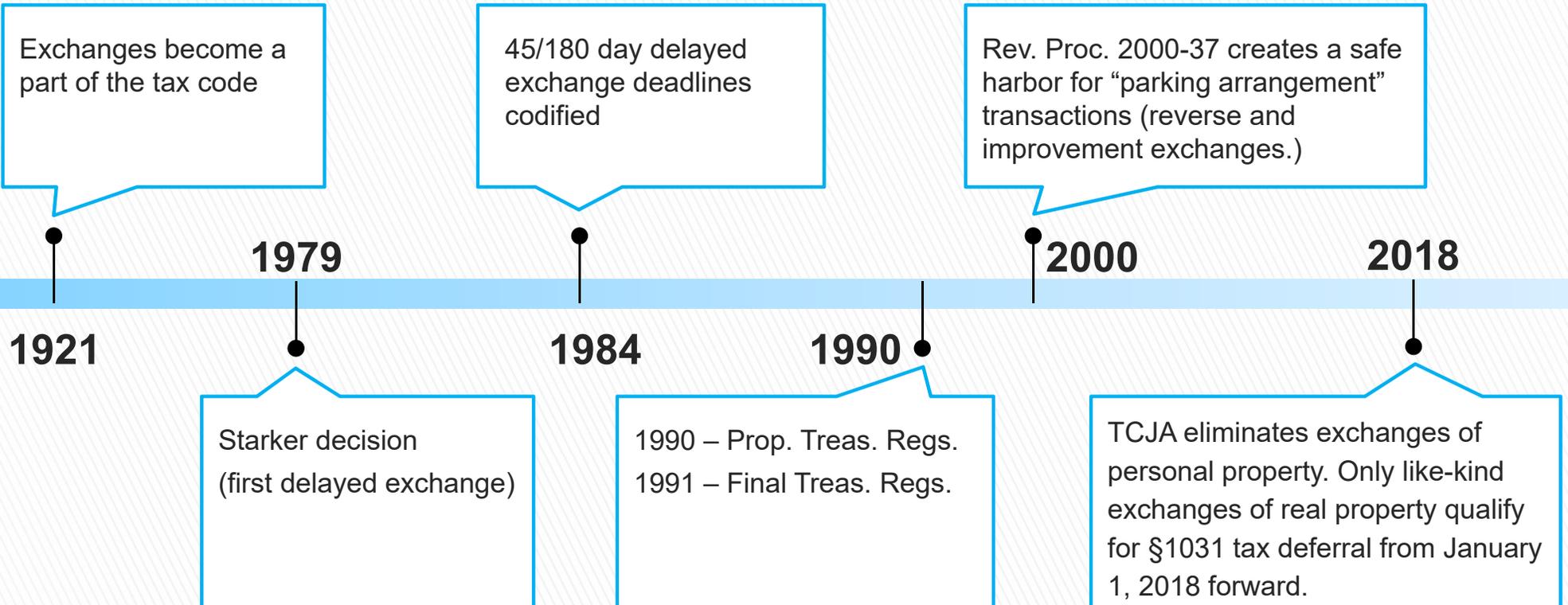
Year 8: April 15, 2027, investor must pay taxes on the original deferred gain minus the 15% reduction.

2027

2029, 100% of the capital gains on new OZ Fund profits are eliminated.

2029

# Legislative History – 1031 Exchanges



# 1031 into OZ Strategy: What Works

- ▶ 1031 exchange rules and OZ rules are separate provisions.
- ▶ However, an OZ can be a fallback position for 1031 investors.
- ▶ Investor initiates a 1031 exchange and does not find suitable replacement property within 45 days.
- ▶ Investor notifies QI that they haven't identified any replacement property and want 1031 proceeds back on day 46.
- ▶ QI releases exchange proceeds to investor on day 46.
- ▶ Investor has 135 more days (up to 180 days from the sale of relinquished property) to invest proceeds into an OZ Fund.
- ▶ Since changing strategy from 1031 to OZ, the investor only needs to invest the gain (not all net proceeds) into OZ Fund.

# 1031 into OZ Strategy: What Works

- ▶ Entity (must be a partnership or corporation, not a disregarded entity or can be an LLC that converts tax status to a partnership or corporation) completes a 1031 exchange.
- ▶ Post-1031 exchange, the entity then elects for OZ Fund status for the entity.
- ▶ Then new OZ Funds coming from deferred capital gain from another source are used to substantially improve the 1031 replacement property.
- ▶ This results in the gain in the 1031 exchange being deferred past 2026 (until the investor sells in a later taxable sale) and separately the gain deferred in the OZ Fund used for improvements qualifying for OZ tax treatment.

# 1031 into OZ Strategy: What Works

When selling a relinquished property held for investment, an investor has 3 options involving 1031 and OZ:

1. Initiate a 1031 exchange;
2. Invest gain into a OZ Fund;
3. Both: Split the proceeds and allocate some funds to a 1031 exchange and also invest some proceeds into an OZ Fund. Using this third combined 1031 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 going towards the OZ Fund.

# 1031/OZ Strategy: What Doesn't Work

1. Cannot do a 1031 exchange into an OZ Fund.
  - The OZ Fund is a fund and not like-kind real property needed for 1031 exchange deferral.
2. Cannot identify property in 45 days and not purchase all the identified property and invest remaining proceeds in a OZ Fund.
  - 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 outside the 180 day reinvestment time period required by OZ rules and not eligible to invest into a OZ Fund.

# Comparison: OZ versus 1031

## Relinquished Property Character and Use



**OZ:** Any property that results in capital gain

- Can be real property or personal property.

**1031:** Must be real property only

- No personal property even if the property was used in or on real property as part of a business.

# Comparison: OZ versus 1031

## Replacement Property Character and Use



**OZ:** Any tangible property used in a trade or business located in a OZ

- Can be real property or personal property.

**1031:** Must be real property only

- No personal property even if the property was used in or on real property as part of a business.

# Comparison: OZ versus 1031

## Reinvest all Net Equity



### OZ: No (Only the capital gain invested)

- If an investor sells an asset for \$7 million with \$2 million of gain, only the \$2 million in gain needs to be invested.

### 1031: Yes (for full tax deferral)

- The 1031 investor needs to reinvest the net equity and have the same or a greater amount of debt. Another way of saying this is to purchase at the same or greater net sales price and spend all the equity. If the investor in the example above sold in a 1031 exchanger for \$7 million with \$3 million net equity and \$3.5 million debt, they would need to reinvest the full \$3 million in net proceeds and have \$3.5 million or more in debt on the 1031 replacement property or properties.

# Comparison: OZ versus 1031

## “Like-Kind” Requirement



**OZ: No**

- Any type of qualifying investment permitted.

**1031: Yes**

- Only real property qualifies for 1031 deferral.

# Comparison: OZ versus 1031

## Qualified Intermediary (QI) Required



**OZ: No**

**1031: Yes**

# Comparison: OZ versus 1031

## Time Requirement for Reinvestment

OZ: 180 days

1031: 180 days

# Comparison: OZ versus 1031

## Tax Deferral on Deferred Gain

OZ: Yes

- But ends on December 31, 2026



1031: Yes

- Can be permanent tax deferral

# Comparison: OZ versus 1031

## Time Restrictions on Holding

**OZ: Yes**

- 5, 7, and 10 year time periods



**1031: No**

- Only must be held for investment

# Comparison: OZ versus 1031

## Location

**OZ: No**

- Only in opportunity zones

**1031: Yes**

- Anywhere in the United States



# Comparison: OZ versus 1031

## Identification Requirements



**OZ: No**

- Must be in an OZ

**1031: Yes**

- Investor must identify replacement property within 45 days and there are limits on the number that can be identified under the 3 Property Rule, 200% Rule or 95% Rule.

# Comparison: OZ versus 1031

## LLC or Partnership Interests



**OZ: Yes.** The entire partnership or any of the partners may opt for tax deferral.

- Similar rules also apply to other entities such as trusts, estates and S Corps.

**1031: No,** cannot perform a 1031 exchange on a LLC member interest or a partnership interest.

- This often creates challenges when not all partners in a partnership want tax deferral in a 1031 exchange.

# Comparison: OZ versus 1031

## Stock in Corporations



OZ: Yes

1031: No

# Comparison: OZ versus 1031

## Additional Capital Requirements

**OZ: Yes**

- The OZ Fund must either create a new business located in a OZ or substantially improve an existing business located in an OZ.



**1031: No**

# Comparison: OZ versus 1031

## Related Parties

**OZ: No**

- Purchase from a related party not permitted.

**1031: No/Yes**

- Some prohibitions on related party exchanges when purchasing from a related party (unless the related party exchanges) and a potential 2 year hold period post-exchange required in other situations such as a simultaneous exchange.



# Comparison: OZ versus 1031

## Basis Step-up Reducing Deferred Gain



**OZ: Yes**

- 10% basis step-up if holding OZ investment for 5 years and a 15% basis step-up if holding investment 7 years

**1031: No**

# Comparison: OZ versus 1031

## Permanent Tax Deferral

**OZ: Yes/No**

- Only on the OZ gain (not the deferred gain)



**1031: Yes**

- Can be permanent on all gain

# Comparison: OZ versus 1031

## Tax Deferral of When Deferred Gain would Normally be Recognized

OZ: Yes, but....

- Ends on December 31, 2026



1031: Yes

# Summary: 1031 and OZ

- ▶ OZ investments from gains not related to the sale of real property provide considerable tax advantages for investors.
- ▶ An OZ investment can be advantageous for investors selling businesses where some of the sale price consists of significant goodwill and/or personal property since personal property is no longer eligible for Section 1031 tax deferral after TCJA.
- ▶ OZ investments provide a new alternative for tax deferral until the end of 2021. Investors have about 2.5 years left to decide to make an investment into an OZ.
- ▶ Both reducing taxes on the deferred gain by up to 15% and pushing the payment of taxes back many years help investors boost ROI.

# Summary: 1031 and OZ

For investors selling real property held for investment, 1031 exchanges provide significant advantages to OZ:

- 1. Control:** Unlike an OZ investment in which the investor has little or not control over their investment, 1031 exchange investors retain full control over their investment into a replacement property. The investor can choose to do a subsequent 1031 exchange (or a series of 1031 exchanges over time) compared to an OZ investor, who for maximum tax advantages, must hold the investment for at least 10 years.
- 2. Tax Deferral:** In an OZ, the investor owes taxes on gain at the end of December, 2026 (due on April 15, 2027). In a 1031 exchange, taxes are deferred as long as the investor continues to reinvest for full tax deferral in subsequent 1031 exchanges.

# Summary: 1031 and OZ

For investors selling real property held for investment, 1031 exchanges provide significant advantages to OZ:

- 3. Flexibility and Timing:** An investor can choose when to pay taxes by selecting the amount and timing of any cash boot or mortgage boot received in a 1031 exchange. OZ rules do not allow for this flexibility and timing.
- 4. Step-up in Basis:** 1031 exchanges allow for a full step-up in basis to heirs.
- 5. Real Estate Related Tax Deductions:** A 1031 exchange investor receives all the real estate related tax deductions for owning investment real property. OZ investors do not receive all of these investment property tax deductions directly since they invest money into an OZ Fund, not direct ownership of real property.

# Summary: 1031 and OZ

For investors selling real property held for investment, 1031 exchanges provide significant advantages to OZ:

- 6. Opportunity to Refinance:** After a 1031 exchange is complete, an investor can do a cash-out refinance. The IRS has not addressed refinancing related to OZ investments.
- 7. Sell Assets to Pay Taxes:** Unless an investor has the cash available to pay taxes on 85% of the original deferred gain, they may be forced to sell other assets to generate the cash needed to pay taxes owed at the end of 2026. A 1031 investor does not face this potential liquidity crunch to pay taxes and has more control on the timing of taxes owed.

# Asset Preservation: Social Media



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