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Opportunity Zones: Assessing the Risk and Reward for Real Estate Investors

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The 2017 Tax Cuts and Jobs Act preserved many of the tax benefits available to investors in real estate and also provided several new incentives around this asset class. One new incentive is known as the Qualified Opportunity Zone program. The goal of the program is to drive private investment into real estate and businesses located in economically underserved neighborhoods throughout the country, known as Opportunity Zones, by providing meaningful tax incentives to those investors. With the IRS recently providing additional guidelines and clarification on the new tax code laid out by the 2017 Tax Cuts and Jobs Act, the potential benefits to real estate investors are becoming clearer.

This new program allows for a taxpayer to elect to defer all or part of a taxable gain by investing in an Opportunity Zone Fund property within 180 days from the date of the sale of the appreciated asset. The tax deferral is granted until the earlier of the date that the Opportunity Zone Fund property is either sold or exchanged, or December 31, 2026. The program also provides for a partial exclusion of the deferred capital gain of 10% after a five-year holding period in an Opportunity Zone Fund and an additional 5% step up in basis after a seven-year hold. Perhaps one of the most significant benefits is that any investment of capital gain held in an Opportunity Zone Fund for greater than 10 years will not incur any capital gains tax on the appreciation of the initial investment upon the sale. Additional funds added beyond the taxpayer's initial investment are not sheltered from capital gains taxes on the appreciation. For more information on Qualified Opportunity Zones, please see our Wealth Planning Update: Qualified Opportunity Zones: What the Proposed Regulations Reveal.

While the program provides for a number of tax incentives for investment into Qualified Opportunity Zone Funds, investors should fully consider the merits of the specific investment in relation to their personal financial goals, beyond the tax benefits. This white paper will consider the potential benefits and challenges of Opportunity Zone investments and provide a comparison to a long-standing tax deferral strategy for real estate investors—the 1031 Exchange.

Benefits and challenges of Opportunity Zone investments for investors

Some of the benefits of investing in Opportunity Zones are both new and significant. First, any capital gain can—in part or in full—be deferred by investing into an Opportunity Zone Fund, an entity organized as a corporation or partnership in order to receive and invest funds in a Qualified Opportunity Zone property (such as Qualified Opportunity stocks, Qualified Opportunity partnership interests, and Qualified Opportunity Zones). Due to the potential tax benefits, this will likely make Opportunity Zone Funds an attractive option for business owners or investors with highly appreciated assets. Second, while geographically constrained, Opportunity Zone Funds can invest in businesses or real estate, which could open additional opportunities and increase the possibility for diversification for fund investors. The tax implication benefits appear to be clear: investors are only required to invest a recognized capital gain of an appreciated investment into Opportunity Zone Funds, meaning that they are entitled to a return of the cost basis in the relinquished asset. If the funds remain invested in an Opportunity Zone for five years, the investor receives a 10% exclusion of the deferred gain from the previous asset sold. If the funds remain invested for seven years, the investor receives an additional 5% step up, for a total exclusion of 15%. Finally, assuming that all investment criteria are met and the funds remain invested for 10 years, any capital gain carried into the Opportunity Zone Fund from the relinquished asset has the potential to grow tax-free until the earlier of when the asset is sold or December 31, 2047.

There are a few noteworthy potential challenges and complications of investing in Opportunity Zones. First, since the intent of the program is to improve underserved neighborhoods, there are capital infusion requirements (one dollar spent on improvements for every dollar spent on the underlying investment) that must be met within a 30-month period. By nature, this requirement dictates that Opportunity Zone investments will be development or significant redevelopment projects, which carry a certain amount of investor risk. Additionally, there are timing requirements that need to be met (the taxpayer must be invested in the fund within 180 days of the sale of the "downleg" asset or, in the case of an individual partner reinvesting proceeds, the last day of the partnership's tax year). Furthermore, due to the development or repositioning requirement for each real estate project, it is not anticipated that these investments will provide a stable (if any) cash flow yield during the first few years, which may be an important aspect for some investors. Finally, there is the risk associated with the underlying investments. Not only do investors have exposure to traditional real estate investment risk such as real estate market conditions, illiquidity risk, tenant credit risk, vacancy, functional obsolesce, and economic cycles, but they also face the added exposure to development and construction risk including cost overruns, construction delays, as well as lack of demand for built product that can affect the viability and performance of the underlying assets and can have a significant effect on the overall performance of the investment.

Comparing and contrasting Opportunity Zones and 1031 Exchanges

As it relates to real estate, there are many differences between the mechanics of a 1031 Tax-Deferred Exchange and Opportunity Zones. Some of the most notable differences include the treatment of deferred capital gains and the investment flexibility that each of these strategies offers.

Capital gains tax deferral differences

Duration of deferral

- **1031 Exchange:** Indefinite, and if deferred until passing of the investor, capital gain tax can be avoided altogether as heirs receive a step up in basis to fair market value.
- **Opportunity Zone:** Capital gain tax must be paid on the earlier of sale of the Opportunity Zone investment or December 31, 2026, although a partial exclusion of the deferred capital gain of up to 15% may be available.

Portability of deferral

- **1031 Exchange:** May be swapped into investment properties of any type and location.
- **Opportunity Zone:** As rules are still being established by tax authorities, it is unclear as to whether one Opportunity Zone investment may be sold and reinvested into another Opportunity Zone investment without triggering a capital gain event. However, it is clear that Opportunity Zone investments cannot be sold and reinvested into non-Opportunity Zone investments without triggering a capital gain event unless held for at least 10 years.

Access to liquidity

- **1031 Exchange:** Entire investment (basis plus gain) must remain invested in real estate. Liquidity may be achieved by refinancing equity in property.
- **Opportunity Zone:** Upon the sale of an asset that has appreciated, original basis may be taken out of the transaction without triggering a capital gain event so long as gain is reinvested in an Opportunity Zone. After 10 years, an Opportunity Zone investment may be sold and converted to cash or reinvested in any asset class without effectively paying any tax on the "gain-on-the-gain."

Investment flexibility

Market and asset selection

- **1031 Exchange:** Investor may only perform a 1031 Tax-Deferred Exchange if selling real estate asset and may only reinvest in real estate asset(s); however, it may be any property type in any location within the 50 United States.
- **Opportunity Zone:** Investor selling nearly any type of highly appreciated asset (stock, business, real estate, etc.) may invest in an Opportunity Zone Fund that will invest in corporate stock, partnership shares, or tangible business property located in an Opportunity Zone, including real estate. There is no requirement for a "like-kind" exchange. This is an entirely new pathway for the sellers of a business or stock and bond portfolio to be able to defer capital gains in this manner.

Timing to invest proceeds

- **1031 Exchange:** Investors have 45 days from the closing on the sale of real estate to identify replacement properties with their Qualified Intermediary and 180 days from the closing of the sale to close on the purchase of the replacement properties. Investors must hire an independent "arm's length" Qualified Intermediary to receive and distribute sale proceeds and document transactions.
- **Opportunity Zone:** Investors have 180 days from a capital gains-triggering event, such as the sale of the highly appreciated asset, to place the proceeds with a Qualified Opportunity Zone Fund. The Opportunity Zone Fund must invest 90% of its assets in Qualified Opportunity Zone property, and the 90% requirement is tested annually. The Opportunity Zone Fund investment is self-reported. To remain in compliance, 90% of the Qualified Opportunity Zone assets as of the average of two annual testing dates need to qualify as Qualified Opportunity Zone property. Additionally, Qualified Opportunity Zone property must be "substantially improved," which means adding improvements equal to the property's initial basis in any building or improvements (but not land) within a 30-month period. It is also worth noting that the last day to invest qualified gain into an Opportunity Zone project is June 29, 2027 and the proposed deadline for the tax-free exit of any Opportunity Zone project is December 31, 2047.

Use of debt for acquisition

- **1031 Exchange:** Investors may use debt in addition to equity to acquire larger assets and increase their basis. Investors are also able to refinance during the hold period of the investment to pull out equity.
- **Opportunity Zone:** Investors are also able to utilize debt in addition to equity to acquire larger assets. As the regulations are still being written, it is unclear whether investors may use debt to pull out equity during the duration of the investment.

Requirement to invest gains vs. gross proceeds

- **1031 Exchange:** In order to qualify for the full capital gain tax deferral, investors must reinvest the entire gross proceeds into "like-kind" replacement property and cannot remove their basis without triggering a capital gain event.
- **Opportunity Zone:** Investors need only to reinvest the gain portion of the proceeds from a capital gains-triggering event into the Opportunity Zone Fund and are able to remove the basis portion to use as they see fit.

After careful comparison of 1031 Exchanges and Opportunity Zones, those seeking to defer capital gains on the sale of real estate will realize that they are two very different mechanisms with each having their own respective opportunities and risks.

Conclusion

The Qualified Opportunity Zone program is intended to be a catalyst to improving underserved neighborhoods throughout the United States, while providing tax incentives that have never been available before to participating investors. Perhaps the most impactful incentive is that the program provides the means for the deferral of recognizing a capital gain from the sale of any asset (business, stock and bond portfolio, or real estate) by reinvesting the gain into an Opportunity Zone project. For some investors, these tax incentives could be significant. However, strong consideration needs to be given to the underlying real estate or business investment in order to fully assess the merits of the opportunity. Developing real estate located in an underserved neighborhood comes with a higher degree of risk than other types of real estate investment and there is no guarantee of success. However, for the right investor, Opportunity Zone Funds can provide the means to a real estate venture and efficient tax planning strategy. For others, the preservation of the 1031 Exchange under the Tax Act allows for a much higher level of flexibility on the deferral of capital gains tax from the sale of real estate by purchasing any type of investment real estate located anywhere in the United States. Careful consideration should be given to all of these aspects and investors should consult with their tax, legal, and investment professionals as to the implications on their particular circumstances.