EXCERPT

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Using Opportunity Zones Investments with IRC Section 1031 Exchanges

JASON WATKINS, CPA, NOVOGRADAC

A question that qualified opportunity funds (QOFs) often hear from investors is, "I have capital gain deferred through an Internal Revenue Code Section 1031 exchange. How can I invest in your fund?"

The opportunity zones (OZ) incentive provides a great way for taxpayers to temporarily defer taxes on capital gains from an exited or failed 1031 exchange, with the added benefit of no additional capital gains taxes if they hold their QOF investment for 10 years. And since only the gain portion of the sales proceeds must be invested in a QOF to defer the capital gains, the taxpayer also has unrestricted access to the remainder of the sold property's proceeds.

Let's start with a brief explanation of IRC Section 1031 exchanges.

IRC Section 1031 exchanges are delayed exchanges whereby a taxpayer sells a property and then within a certain statutorily required period, acquires a new property. A property owner who holds appreciated real property for productive use in a trade or business or for investment can defer capital gains taxes on that appreciation if the property is exchanged for real property of a like kind which is likewise held for productive use in a trade or business or for investment. There's no limit to how often the property owner can exchange the property and continue to defer capital gains taxes, if they don't receive any cash in the exchange.

When the taxpayer's original property is sold, the proceeds from the sale will be received and held by a qualified intermediary. The taxpayer must identify a like-kind replacement property within 45 days of the sale of the original property and must close on the acquisition of the replacement property within 180 days of the sale. The qualified intermediary will purchase the replacement property on behalf of the taxpayer.

A failure to either identify a replacement like-kind property within 45 days or to close on the replacement property within 180 days will result in a failed 1031 exchange. Any cash received from a failed 1031 exchange or excess cash received after completion of the acquisition of the replacement property is considered boot and will result in some or all capital gains being taxable.

While there is no limit to how often a taxpayer can use a 1031 exchange, they may wish to exit the cycle of locating replacement properties. An investment into a QOF is a good way to achieve this outcome while still maintaining long-term upside. Let's say that a taxpayer would like to sell a residential rental property for $1 million, which would generate a capital gain of $500,000. To use a 1031 exchange to defer all of the gain, the taxpayer would need to use the entire $1 million of sales proceeds to acquire a like-kind replacement property. However, if the same taxpayer uses an OZ investment, they will need to invest only the capital gains portion of $500,000 into a QOF to defer the gain. It is important to note that the OZ deferral is only temporary and the $500,000 of capital gain will become taxable Dec. 31, 2026. That said,

using an OZ investment will free up the $500,000 of nongain sales proceeds for other use by the taxpayer.

If the taxpayer holds their QOF investment for at least 10 years, there will be no capital gains taxes or depreciation recapture on the ultimate sale of the either their QOF investment or the underlying property.

Another common scenario is a taxpayer who is unable to locate a replacement like-kind property that will use all proceeds from the sale of their original property. Using the earlier facts, let's say that the replacement property identified will cost $800,000 and the investor will receive $200,000 in cash. As noted earlier, any cash received from the original property sale is boot that results in at least some of the capital gain being taxable. Since the capital gain from the sale was $500,000, the $200,000 of cash received will result in $200,000 of taxable capital gains. In this situation, the taxpayer can simply invest the $200,000 into a QOF and both temporarily defer the gain and potentially participate in a tax-free exit should they hold their investment for 10 years.

Conclusion: Options Available

The OZ incentive has provided an excellent opportunity for taxpayers that have traditionally used 1031 exchanges to defer capital gains on property sales to exit the 1031 exchange cycle while continuing to receive tax benefits and potentially a greater tax-free upside at an eventual cash sale. Both incentives can be complicated with myriad rules and regulations that must be followed. Accordingly, taxpayers are encouraged to consult with their tax professionals when considering 1031 exchanges and opportunity zone investments. ❖

Novogradac Services Contact
Jason Watkins, CPA
Jason.Watkins@novoco.com
330-365-5409

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