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Op Funds Expand Deferral Paths for CRE Investors

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BOSTON — The Tax Cuts and Jobs Act of 2017 created the Opportunity Zone program which provides real estate investors a new tool to defer gains from sales or exchanges of capital assets by investing those gains in a “Qualified Opportunity Fund.”

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The program aims to stimulate investment in economically disadvantaged areas by deferring capital gains recognition for up to seven years if the gain is invested in a Fund, and avoiding capital gains on the appreciation of the Fund investment after a 10-year holding period. While there are unanswered questions regarding the tax consequences of dispositions of property within the Fund itself, the tax benefits are clearly established

and offer several distinct advantages over Section 1031 like-kind exchanges.

The new law comes under Section 1400Z of the Internal Revenue Code (“1400Z”). A Fund under 1400Z could be as simple as a two-member LLC or as complex as a large C corporation with hundreds of shareholders. A Fund must be a partnership or corporation for U.S. income tax purposes, has to “self-certify” as a Fund in the first tax year that it intends to so qualify, and must hold at least 90 percent of its stock, partnership interests or business assets in Qualified Opportunity Zone (“Zone”) property. Tangible property qualifies if (a) it was purchased after December 31, 2017; (b) the original use of the property commences with



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the Fund or the Fund “substantially improves” the property, and; (c) during “substantially all” of the Fund’s holding period, “substantially all” of the property’s use is within a Zone.

1400Z provides that each state may select up to 25 percent of its low-income communities for potential designation as Zones. Massachusetts submitted a list of 138 low-income census tracts for designation as Zones, all of which the U.S. Treasury so designated. The U.S. Treasury Community Development Financial Institutions (CDFI) Fund provides links to several Qualified Opportunity Zone program resources on its website, including a searchable map of Zone tracts.¹

1400Z provides that “[i]n the case of gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer,” the taxpayer will not recognize gain if he or she invests an amount at least equal to that gain in a Fund with-

in 180 days of the sale or exchange. The taxpayer’s basis in the Fund investment will be zero for the first five years. After five years, the basis increases to 10 percent of the deferred gain; after 7 years, it increases by an additional 5 percent. Gain on the amount that the taxpayer invests in the Fund will be deferred until the earlier of the date on which the investment is sold or December 31, 2026. Therefore, if the taxpayer sells a capital asset in 2019, invests in a Fund within 180 days, and holds the investment until 2027, then the taxpayer excludes 15 percent of the original gain from tax and defers recognition of that gain from 2019 to 2026. The real payoff is after 10 years, when the taxpayer can increase the basis in the Fund investment to its fair market value on the date sold or exchanged—all appreciation will then avoid tax.

Example: On January 1, 2019, Ellen sells an office building with an adjusted basis of \$200,000 for a contract price of \$300,000. On January 15, 2019, Ellen in-

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¹ See <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>.

Opportunity Zones

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vests the portion of the proceeds representing capital gain (\$100,000) in a Fund and keeps the \$200,000 as a non-taxable return of basis. Ellen does not have to recognize the \$100,000 in capital gains until December 31, 2026, when she will report an adjusted basis in the Fund investment of \$15,000 and a capital gain of \$85,000 because she held the investment for seven years before December 31, 2026. Her adjusted basis in the investment after December 31, 2026 is \$100,000. If Ellen sells her Fund investment for \$200,000 on January 16, 2029 (10 years and one day after her initial investment), she can elect to increase her adjusted basis in the investment from \$100,000 to the fair market value of \$200,000, thereby avoiding capital gains on the \$100,000 appreciation.

Real estate investors have long understood and used like-kind exchanges under section 1031. Both 1400Z and 1031 require closing on the second investment within 180 days and offer the possibility to defer capital gains, but that is where their similarities end. 1400Z provides for deferral of capital gain on “any property held by the taxpayer,” whereas 1031 is limited to like-kind real property. 1400Z provides that the taxpayer only needs to invest disposition gain in a Fund and can thus retain his or her adjusted basis as a return of capital. If a taxpayer only wants to reinvest a portion of the total proceeds in a 1031 exchange, the taxpayer will recognize gain on the retained cash. Further, there are no geographical restrictions on qualified replacement property under 1031, unlike 1400Z. Unlike 1031, 1400Z does not require the taxpayer to identify the Fund investment within 45 days or to acquire the investment through a qualified intermediary.

1031 exchange property can be transferred after a two-year safe harbor (or less than two years under a facts and circumstances test), but a taxpayer is locked into a Fund investment for 10 years to maximize tax benefits. Even if the taxpayer holds the investment for 10 years, it is unclear how much freedom the Fund itself has to exchange one Zone property for



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another without incurring capital gains.

For investors who intend to hold assets for at least 10 years, 1400Z provides an advantage over 1031 by allowing taxpayers to avoid gain recognition on the appreciation of the Fund investment.

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Investors under 1031 carry over their adjusted bases and do not have a similar opportunity to avoid gain on the appreciation of the replacement property (at least during their lifetimes). Unlike 1031 investors, Fund investors under 1400Z will recognize capital gains on the disposition of the original property in tax year 2026 at the latest—appreciation in the Fund investment will avoid tax if held for 10

years, but capital gain on most of the original sale gain is only temporarily deferred.

While there are some remaining questions, 1400Z creates a powerful new vehicle that allows real estate investors to defer gain on the sale of real property while stimulating investment in economically disadvantaged areas. Many taxpayers will prefer the immediacy of like-kind exchanges under section 1031 over the extended timeline for tax benefits under 1400Z, but patient investors who anticipate a steady increase in the value of their Fund investment will be rewarded in the form of a step-up in basis after a 10-year holding period. This step-up in basis offers a significant advantage over section 1031 by enabling the taxpayer to cash out after 10 years, which provides increased liquidity for retirement or estate planning purposes at a relatively low tax cost. ■

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