No, Opportunity Zone Investments Will Not Replace Section 1031 Exchanges

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As everybody probably knows by now, I've been part of the enthusiastic chorus of advisors singing the praises of the Opportunity Zone Program. Make no mistake: the program is a game-changer for private equity and the real estate industry. We've already seen widespread impact across the country in many markets where Opportunity Zones are located.

But some of the hype has led commentators to declare the end of the Section 1031 exchange. As the Opportunity Zone program takes shape, and as I conduct in-depth conversations with clients and advisors about taking advantage of the tax incentives, the way taxpayers will approach the program has become increasingly clear. My prediction based on these conversations is that Qualified Opportunity Funds will primarily be capitalized with proceeds of sales from non-real estate assets, such as stocks, bonds, alternatives (including REITs, which are not 1031-eligible), closely held businesses, artwork, and classic cars. For sellers of real estate, Section 1031 exchanges will still be the primary tax strategy. Here's my rationale:

- **First and foremost - THERE'S NO BOOT NETTING under the Proposed Regulations**. What do I mean? Consider an example: I own a fully depreciated rental property I have cash-out refinanced several times. The income tax basis is zero, the fair market value is $1,000, and the remaining mortgage balance is $700. If I sell the property, I end up with $300 in net cash after paying back the bank, but I have capital gain of $1,000 (we're assuming there's no ordinary income recapture -- see below). If I want to defer taxes in a Section 1031 exchange, I can "boot net" the $700 of debt, meaning I merely need to reinvest my $300 of equity and take out a new mortgage of at least $700 on my replacement property. The mortgage boot is "netted out," and I end up

with no net taxable gain. If I want to defer taxes in a Qualified Opportunity Fund (QOF), I can't get credit for what the QOF borrows to acquire its property, even if I personally guarantee the debt. So I'll need to cross-collateralize and borrow $700 from someplace else, or I can come out of pocket for $700 if I have it. For most real estate owners with highly leveraged property, either option will be too difficult a pill to swallow.

- **Speaking of recapture... that can't be deferred under the Opportunity Zone program, either.** Real estate sales can result in two forms of ordinary income recapture. The first is under Section 1250, which recaptures the difference between accelerated and straight-line depreciation taken on properties purchased before 1986. The second, which is much more common, is Section 1245 recapture, which comes from the personal property appurtenant to the real estate sold that was depreciated based on the MACRS rules. In either case, the Proposed Regulations for QOFs made pretty clear that an investment into a QOF cannot defer taxes on ordinary income recapture. Although the Tax Cuts and Jobs Act limited Section 1031 exchanges to real property and not personal property, investors can still defer Section 1250 recapture, and they'll have planning options for Section 1245 recapture. When it comes to Section 1245 recapture, exchangers can purchase a corresponding amount of personal property or qualified real property (QRP) subject to immediate expensing under the TCJA, and as long as the replacement property was purchased within the same taxable year as the sale of the relinquished property, the resulting deduction would zap out the ordinary income recapture. Moreover, I hold out hope that the eventual Section 1031 regulations in the wake of the TCJA will allow the deferral of gain corresponding to appurtenant personal property, which I still believe is the most likely way the IRS will go.
- **The deferral in a QOF is until 2026, but the deferral in a Section 1031 exchange is forever.** For investments in Qualified Opportunity Funds, the deferred capital gains will come due at the close of the 2026 tax year, come hell or high water. There is no due date on the deferred capital gains in a Section 1031 exchange, hence the "defer and die" strategy, in which real estate owners use cash-out refinances to harvest increases in value and save their heirs the income taxes through a step-up in basis. As detailed below, QOF investments don't get a step-up in basis upon death because of a statutory exception, and there are doubts about cash-out refinances in a QOF, so two preferred real estate strategies might be off the table in the QOF context. If real estate owners can't harvest liquidity to pay the taxes due in 2026, they'll be less likely to stomach the mandatory tax bill.
- **The ability to cash-out refinance in a QOF is currently unclear, whereas the "nanosecond rule" applies in a Section 1031 exchange.** The "nanosecond rule," gleaned from statute, regulation, and case law, states that a taxpayer can begin the process to cash-out refinance one nanosecond after closing on a replacement property. With QOFs, the statute and regulations imply that cash-out refinances are a dicey proposition, but the IRS has not yet directly addressed the topic with more rounds of regulations to come. Congress legislatively delegated anti-abuse regulations to the IRS, so we can expect the Service to weigh in eventually, but we're in an uncertain environment in the meantime. What seems abusive is the idea of a QOF closing on real estate on Day 1, then starting the cash-out refinance process on Day 2, a la the nanosecond rule. Without having a "boot netting" rule, instant refinances are unlikely to get the same latitude they do in the Section 1031 context. My prediction: future

regulations institute a two-year moratorium on cash-out refinances in QOFs. It's not out of the question for the IRS to prohibit cash-out refinances entirely, though that would hamper taxpayers' ability to pay the 2026 capital gains taxes without liquidating the asset and giving up the ten-year tax benefits that drive the entire Opportunity Zone program. While we wait for regulations to clarify what will happen with cash-out refinances, expect sellers of real estate to remain skeptical of this aspect of the Opportunity Zone laws.

- **Effectively, there is no step-up in basis for a decedent's QOF investment.** Under Section 1400Z-2(e)(3) of the Code, a decedent's estate still recognizes the income deferred under the Opportunity Zone program under Section 691 of the Code, effectively zapping out the step-up in basis on the QOF investment. This is a sharp deviation from the outcome in a Section 1031 exchange, whereby the step-up in basis applies as normal (i.e., an unlimited basis adjustment) and all built-in capital gain gets wiped out upon death. For real estate owners, the step-up in basis is a core component of estate planning, and combining the step-up with an irrevocable life insurance trust (ILIT) is absolutely crucial in business succession planning. With a QOF, deferred gain might now be subject to two layers of tax: income tax *and* estate tax, akin to the outcome for qualified plan assets in a taxable estate.
- **Section 1031 Exchanges don't limit location within the United States.** As long as a Section 1031 exchange involves U.S.-based property getting exchanged for U.S.-based property, a taxpayer may choose real estate in any location across the country. For QOFs, real estate investments will be limited to Opportunity Zones. The issue for some savvy and experienced real estate investors will be finding an economically viable investment within markets they already know. In Opportunity Zones within major metropolitan areas, real estate prices have already spiked by as much as 80%. With Amazon's announcement that it will locate half of its HQ2 in a Long Island City Opportunity Zone, we may see surrounding Opportunity Zone property skyrocket even further in value, with the reverberations reaching as far and wide as Suffolk County. For real estate investors who stick to neighborhoods they know, Section 1031 exchanges will almost certainly be the way to go.
- **Taxpayers can still use Section 1031 exchanges to invest in private equity deals.** Although the structuring for this strategy often proves difficult, I have assisted taxpayers regularly for years when they desire to enter a private equity investment alongside a sponsor as replacement property in a Section 1031 exchange. For Delaware Statutory Trusts and certain syndicated Tenant-in-Common (TIC) investments, the process is quite easy. For traditional real estate private equity investments, structuring is much harder, but still quite possible when all parties are sufficiently sophisticated and motivated. So it's incorrect to assume that QOFs are the only avenue to defer real estate sale proceeds into private equity vehicles.
- **Taking basis back from the closing table in the form of tax-free cash is useless when the taxpayer's real estate has little or no basis.** For many seasoned real estate investors, they have used Section 1031 to defer capital gains for such a long time that their property is fully depreciated and has very little or no tax basis to harvest at the closing table when trying to defer into a QOF. Even if the taxpayer does have substantial basis, the benefit would be useless if the taxpayer has to borrow money from another source to replace leverage on the property sold (see above).

- **Exception: Real estate in S-Corps will be ripe for the Opportunity Zone program.** As I mentioned in my write-up on the Proposed Regulations, owners of real estate in Subchapter S corporations have the unique chance to circumvent Section 311(b) and get rid of their S-Corporation tax-free. When multiple shareholders own an S-Corp holding real estate, they are unable to "drop and swap" in order to part ways using a Section 1031 exchange, so the Opportunity Zone program represents an amazing exit strategy for those shareholders. Because real estate S-Corps (1) have typically been in existence for a very long time, (2) are subject to harsher tax rules when trying to cash-out refinance, and (3) do not have the benefit of a Section 754 election when a shareholder dies, the considerations detailed above do not apply nearly as much.
- **Wait a second... why do I have to choose? Can I get both Section 1031 benefits and Opportunity Zone benefits?** It'll be really difficult. The Opportunity Zone program mandates an investment into a QOF, which must be a corporation or partnership, but Section 1031 exchanges mandate acquisition of real property interests. Corporate stock and partnership interests are explicitly forbidden as replacement property in Section 1031 exchanges. So a taxpayer has no chance of completing a Section 1031 exchange into a QOF. Taxpayers also cannot "bail out" of a Section 1031 exchange after they have already identified property, because the 1031 regulations require qualified intermediaries to hold on to the cash in escrow all the way up until the expiration of the 180-day period (which cannot be extended when a taxpayer sells direct interests in real estate, as opposed to selling real estate through a pass-thru entity, in which case taxpayers can elect for the 180-day clock to start at the close of the taxable year). The best a taxpayer can do is decline to identify after 45 days, take the money back, and put the money into a QOF before the 180-day clock has expired. Two strategies come to mind in the Section 1031 context that might allow some synergy with QOFs:

1. Have a disregarded entity (a single-member LLC) or an S-Corp complete a Section 1031 exchange, then elect QOF status for the entity (single-member LLCs will need to convert their tax status to either a partnership or a corporation) and use deferred capital gain from another source (or syndicated funds) to substantially improve the replacement property. In this case, the gains deferred under Section 1031 still get deferred past 2026, but the gains deferred under the Opportunity Zone program qualify for the QOZ tax benefits.
2. Complete a Section 1031 exchange into a QOZ property, then sell the QOZ property to a QOF in a gain recognition transaction, and reinvest part or all of the resulting capital gain into the QOF for less than 20% equity interest in the QOF. If the exchanger's interest in the QOF is greater than 20%, both the taxpayer and the QOF risk penalties under the prohibition against related-party transactions under the Opportunity Zone program.

Perhaps those strategies may prove useful in the right circumstances, but I imagine most sellers of real estate will still opt for a straight Section 1031 exchange when given the choice between incentives (with a probable exception for those stuck in S-Corps). For sellers of non-real estate capital assets, however, they no longer have the luxury of Section 1031 deferral, so the Opportunity Zone program is their only avenue to seize tax advantages.

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