The Georgia Society of Certified Public Accountants

Comparing 1031 Exchanges to Opportunity Zones (1031 v. 1400z-1 and 1400z-2)

With the passage of the Tax Cuts and Jobs Act in 2017, Qualified Opportunity Zones ("QOZs") have become the latest craze in the real estate and tax worlds. Less than two years after QOZs were added to the internal revenue code, almost every major financial and real estate publication has raved about them and their potential tax benefits. One particular Forbes article named QOZs "the most unbelievable tax break ever." Another article in the Wall Street Journal called QOZs the "jackpot" of all tax-breaks. All of this hype has caused QOZs to become an ubiquitous topic of discussion. Unfortunately, however, when planners peel back the layers of the QOZ provisions and regulations, it becomes obvious that QOZs are not a perfect fit for every individual holding an unrecognized capital gain. Additionally, any potential benefits of the QOZ should be compared to other tax deferral or elimination strategies such as a Section 1031 like-kind exchange. Upon a comparison of these two strategies it is sometimes surprising to advisors and clients that the like-kind exchange remains the superior option depending on the facts and circumstances.

COMPARING LIKE-KIND EXCHANGES TO QOZS

Tax Benefits:

QOZs provide three primary tax benefits. First, QOZs provide deferral of capital gains for a specific period, not to extend beyond December 31, 2026. Second, QOZs provide up to a 15% increase in basis of the original unrecognized capital gains upon attaining certain "holding period" thresholds. Finally, QOZs offer the potential for unlimited tax-free growth on the QOZ investment if the investment continues to appreciate in value and the gain is left invested for at least ten years.

Similarly to QOZs, like-kind exchanges also permit the deferral of unrecognized capital gains. Unlike QOZs, however, the deferred gain in a like-kind exchange can be completely eliminated altogether. In a like-kind exchange, the recognition of the deferred gain does not occur until the individual sells a like-kind property without the completion of a follow-up like-kind exchange. While like-kind exchanges do not offer a 15% increase in basis or a tax-free growth on the original investment, like-kind exchanges permit a full basis step-up upon the death of an individual who holds the real property pursuant to Section 1014 of the Tax Code. If properly structured, the benefit of a full step-up in basis would likely exceed the 15% basis increase and tax-free growth offered by QOZs because it would completely eliminate any inherent gain in the property. Additionally, one must consider whether the investment in the QOZ will continue to appreciate in value so as to confer the benefit of tax-free growth in the first place.

Non-Tax Benefits:

In addition to tax benefits, QOZs offer some additional perks. For example, the QOZ regulations allow an individual to invest in a 3rd party QOZ Fund. The individual would be able to take a "hands-off" approach to the investment and allow the 3rd party to assume all of the managerial duties of the fund. Additionally, QOZs can be used to defer gains on personal property or intangible property. An individual could also use a QOZ to hold the gain generated from the sale of real property where the owner attempted a like-kind exchange but failed to identify a replacement property within the required 45 days.

Also, unlike QOZs, like-kind exchanges allow for deprecation of replacement property and access to liquidity through refinancing. Finally, like-kind exchanges have significantly fewer regulatory hurdles once the individual has completed the replacement property purchase.

CONCLUSION

Despite the current publicity surrounding QOZs, they are not a "one-size-fits-all" planning opportunity. In many cases, the use of a like-kind exchange will continue to be the client's best option. As with any planning opportunity, the client and his or her advisors should give careful consideration to the use of QOZs or like-kind exchanges and compare the benefits and drawbacks of each. The headlines you see are not necessarily "Fake News"…but as with any tax planning opportunity, the devil is in the details!

Stephanie Friese *is a shareholder in the Atlanta office of Chamberlain Hrdlicka and represents clients in various aspects of commercial real estate transactions including land acquisition, leasing, construction, financing, and disposition. Stephanie Friese may be reached at (404) 665-1220 or by email at Stephanie.Friese@chamberlainlaw.com.*

Christopher A. Steele *is a shareholder in the Atlanta office of Chamberlain Hrdlicka's Trusts and Estates Practice. Christopher counsels clients in a variety of tax, trust, and estate matters, including planning for business owners. Christopher Steele may be reached at (404) 658-5464 or by email at Christopher.Steele@chamberlainlaw.com.*