

# FINANCIAL ADVISORY

## Opportunity Zones: A 1031 Exchange Alternative?

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**A**s a tax-advantaged investment and 1031 Exchange expert, I was intrigued when I first heard of Opportunity Zones. This is a program created by the federal government that is designed to encourage investing in certain areas of the country. It was initially described to me as a “1031 Exchange Alternative.” After much research, I concluded that; while it does work to somewhat ease the pain of capital gains taxes, the Opportunity Zone is a poor alternative to a 1031 Exchange. This month, I will talk about why.

### WHAT OPPORTUNITY ZONES ARE

Opportunity Zones were created to offer tax incentives that would encourage investment in certain areas of the country. Based on that description, one would expect eligible properties to be unattractive; flooded areas of New Orleans, the former Packard factory in Detroit that has been vacant for 60 years, etc. It turns out that this is far from the truth. Opportunity Zones were created by elected officials, so every politician in the country had their hand out to create zones

in “their” neighborhoods. The state of California alone has 879 Opportunity Zones and include areas in Beverly Hills and along Fraternity Row at the University of Southern California.

So; if I invest in an Opportunity Zone, I’m not stuck investing somewhere that I need to wait 10 years for growth? I can invest somewhere with the potential to grow now? I was interested. What are the tax benefits?

### THE TAX BENEFITS – THE ADVANTAGES

If I experience a capital gain from selling stocks, selling real estate without a 1031 Exchange, or any other sort of eligible asset, I can delay paying taxes on that gain if I invest just the gain in a Qualified Opportunity Zone. I will get a 10% discount (in the form of a 10% basis increase) in 7 years, and then will owe taxes on the gains I have deferred. After 10 years, I can sell the Opportunity Zone property and pay zero capital gains on it.

### THE DISADVANTAGES

With an Opportunity Zone, the taxes are still due 7

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years from now but you can't sell the asset for 10 years. This means that you will need to come up with the money from somewhere else to pay your taxes.

An additional disadvantage to the Opportunity Zone plan is that it does not cover Accumulated Depreciation taxes. If I sold real estate, I can defer the Capital Gain (at 15% or 20% to the IRS + 9.3% to California) for 7 years, but my Accumulated Depreciation (25% to the IRS + 9.3% to California) is due the next time I file taxes.

## A CASE STUDY

Let's say that I bought a residential property in 1990 for \$250,000 and that I wrote off 80% of its value for depreciation, since we can't depreciate land, and that I sold it in January of 2021 for \$1,100,000. This gives me \$200,000 ( $\$250,000 \times 80\%$ ) of Accumulated Depreciation and \$850,000 ( $\$1,100,000 - \$250,000$ ) of Capital Gains. Over the last 31 years, I've fully depreciated the property. When I sell the property – without a 1031 Exchange – my taxes due would be ( $\$200,000 \times 34.3\% = \$68,600$ ) + ( $\$850,000 \times 29.3\% =$

$\$249,050$ ) for a total of \$317,650.

If I do an Opportunity Zone, I can delay the payment of that larger amount, but the \$68,600 is due now. In seven years, My basis will increase by 10% ( $\$250,000 \times 1.1\% = \$275,000$ ), so the new Capital Gains Tax will be  $\$825,000 \times (20\% + 9.3\%) = \$241,725$ . (That sure doesn't sound a lot less than \$249,050.) Given our current political climate, do we expect taxes to be the same at that time? Could they be higher?

## WHY I THINK A 1031 EXCHANGE IS BETTER

If I do a 1031 Exchange, of course, I can delay both of these taxes potentially forever. My taxes could come due after I sell my replacement property in the future – but only if I don't do another 1031 Exchange. I may never have to pay them at all. All these taxes will disappear when my heirs receive a stepped up basis upon my death. After all my research, I couldn't understand why one would simply delay paying a tax when he could avoid it altogether. If you have any questions, please call me at (877) 313-1868.

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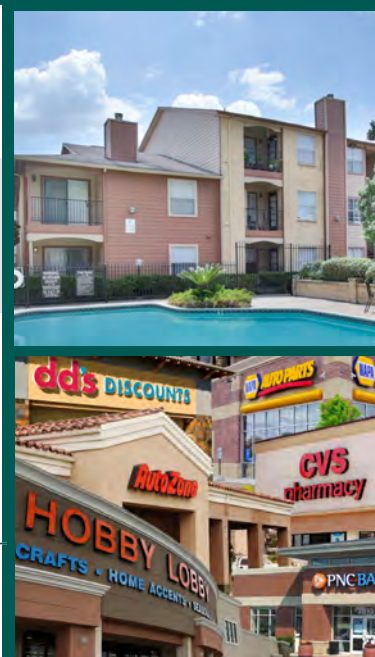
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