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Opportunity Zones vs. 1031 Exchanges & DSTs

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Agenda

- Opportunity Zones: Advantages & Limitations
- Section 1031 Exchange: Advantages & Limitations
- Delaware Statutory Trusts: Advantages & Limitations
- Traditional Section 1031 Exchange vs. DST Investment
- Opportunity Zones vs. 1031/DST
- Other Considerations

What Is An Opportunity Zone Fund?

General Background on Opportunity Zones

- Codified in 2017 via Section 1400Z, per TCJA.
- Place-based tax policy, designed to spur economic revitalization.
- 8,764 census tracts nationwide designated as Opportunity Zones.
- Incentivizes private capital investment.
- Real estate and operating businesses are eligible.

What Is An Opportunity Zone Fund?

Tax Benefits For Capital Gains

- Deferral until December 31, 2026
- Zero capital gains tax liability on subsequent investment after a 10-year hold

Types of Funds

- Single Deal / Multi Asset
- Real Estate / Operating Business
- Sector-Specific / Sector-Agnostic
- Geographically Concentrated / National

What Is An Opportunity Zone Fund?

Advantages

- Capital gain deferral
- Capital gain tax liability elimination
- Depreciation recapture elimination
- Reinvested gain does not have to derive from a real estate investment
- Flexibility with principal and the amount of gain that is reinvested

Limitations

- Geographically restricted
- Patient capital (10-year hold period)
- Perishable incentive (some deadlines have already passed)
- Liquidity issues and tax rate risk
- Opportunistic: must be ground-up or substantial redevelopment
- State conformity issues in CA, MA, ME, NC, and NY

What Is A Section 1031 Exchange?

General Background

- Codified in 1921.
- 1031 refers to Internal Revenue Code Section 1031, which defines the rules and limitations governing this tax break.
- “Swap ’til you drop”
- Key component of tax planning for real estate investors.
- Helps facilitate transaction volume and therefore supports the entire real estate industry.
- A 1031 exchange is a way to “exchange” one “like kind” property for another, while deferring capital gains taxes from the sale of the first property.

What Is A Section 1031 Exchange?

Advantages

- Defer capital gain tax liability.
- Chain together multiple transactions over time, indefinitely.
- Basis step-up to fair market value upon death, benefiting investor’s heirs.
- Investor control, including timing of exit.
- Active management.

Limitations

- Active management.
- Only for real estate transactions.
- Has to be an investment property.
- 45-Day Rule & 180-Day Rule.
- Need to use a Qualified Intermediary.
- Replacement property needs to be of equal or greater value than the property being sold. (Otherwise, the difference in value will be taxable.)

What Is A Delaware Statutory Trust (DST)

General Background

- Enacted in Delaware in 1988.
- Approved for 1031 Exchanges by the IRS in 2004 (RR 2004-86).
- Similar to a Tenants-in-Common structure, but better.
- A DST is an investment vehicle that allows investors to conduct a 1031 Exchange into a replacement property in which they are passive investors (with restrictions).
- Fractionalized ownership of replacement property.
- Trust itself is run by a sponsor, which manages the property.

What Is A Delaware Statutory Trust (DST)

Advantages

- Passive investment.
- Access to institutional-grade real estate with relatively small investment minimum.
- Relative predictability of financial performance.

Limitations

- Generally illiquid.
- Typical holding period of 5-10 years, with little or no control over exit timing.
- All of the limitations of a 1031, plus the “7 Deadly Sins.”

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The “7 Deadly Sins” Of DSTs

1. Once the initial DST offering is closed, investors may not make any additional (new) capital contributions. Typically this risk is mitigated by ensuring there are high reserves in the initial raise.
2. The DST’s trustee may not renegotiate the terms of existing loans, nor may it borrow new funds, except under very limited circumstances.
3. The DST’s trustee may not renegotiate current leases, nor may it enter into new leases, unless there is a tenant bankruptcy or insolvency. Often the DST will enter into a long-term lease contract with an affiliated entity to operate a property at the time it is acquired (this is known as a master lease).
4. Upon the sale of a property owned by a DST, the sale proceeds must be distributed to investors (who can then do a subsequent 1031 exchange, if they want); the trustee may not use sale proceeds to acquire a new property within the DST.
5. A DST’s cash reserves may only be invested in short term debt obligations, rather than more speculative investments. Remember, a DST will often have high cash reserves, since they are unable to raise additional capital from investors.
6. Any cash accrued within the DST in excess of the required reserves must be regularly distributed to the investors. These distributions usually occur on a quarterly schedule.
7. The trustee of a DST may not make significant improvements to a property. Capital expenditures are limited to (a) normal repair and maintenance, (b) minor non-structural capital improvements, and (c) those required by law.

Traditional 1031 Exchange vs. DST Investment

Investment Aspect	Traditional 1031 Exchange	DST Investment
Qualifying investors	Anyone who is selling a real estate investment property	In almost all cases, you must be an accredited investor
Number of investors	One	Unlimited, though often capped at 499
Ownership	Ownership in an individual real estate property	Ownership in a trust, which owns real estate property
Risk profile / strategy	Core, core-plus, value-add, or opportunistic	Core or core-plus only
Real estate price range	Approximately equal to the value of the individual investor's "sold" property	Vary; may be up to $100 million or more
Control & management	Active	Passive
Holding period	Any	Typically 5-10 years
Liquidity	Generally liquid	Generally illiquid
Restrictions of "7 Deadly Sins"?	No	Yes

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Opportunity Zones vs. 1031/DST

Investment Aspect	Opportunity Zone	1031/DST
Full Tax Benefit Timeline	After a 10-year holding period	Upon death
Triple Net Leasing	Not allowed	Allowed
Investment Eligibility	Any type of gain. Can be invested into a QOF that holds real estate and/or operating business(es).	Must be proceeds from investment real estate. Can only be invested into a replacement property or replacement property interests.
Investment Amount	Tax benefit applies only to the gain. Can rollover full or partial gain.	Principal and gain amount must be rolled over for the full benefit.
Focus	Capital Appreciation	Varies (Traditional 1031) Stable Cash Flow (DST)
Timeline For Investment	180 Days	45-Day Rule & 180-Day Rule
Ease Of Investment	Self-Certification	Qualified Intermediary
Investor/Advisor Knowledge Of Program	Limited	Healthy

Other Considerations

- OZs can be a fallback for a failed 1031 or DST investment.
  - 45-Day Rule failure: 135 days left to do an OZ investment.
- Is Section 1014 (stepped-up basis upon inheritance) in jeopardy?
- Are OZs here to stay?

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