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Opportunity after the unsuccessful exchange - by Kyle Kadish

November 11, 2022 - Financial Digest



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Like-kind exchanges have been occurring in some form or fashion for over 100 years. More recently codified as a 1031 exchange, real estate investors continue to actively defer taxes when selling investment property and replacing it with other property. As a good tax policy, the belief is that the exchangor will invest additional funds into the new property(ties), stimulating the economy and increasing the value. Dealing with the government has some strings attached; the 1031 exchange investor has a strict timeline to complete their transactions.

Upon sale, the exchangor has up to 45 days to identify their intended replacement property(ties). After identification, the exchangor must complete all purchases within 180 days from the sale of their relinquished property. A 1031 exchange is unsuccessful if the investor fails to identify replacement property or purchase the identified property within the given timeline. The failed exchange triggers the exchangor's taxable event. Nevertheless, opportunities remain for deferring taxes for the investor through other tax strategies.

In 2017's Tax Cut & Jobs Act, Qualified Opportunity Zone (QOZ) legislation created an economic development tool that allows investors to invest in distressed communities nationwide. The bipartisan efforts of New Jersey's senator Booker and senator Scott from South Carolina incentivized investors with tax benefits for spurring economic growth. Governors from all 50 states nominated neighborhoods and counties to qualify, with the US Department of Treasury certifying those areas. An investment within a QOZ encourages investments in over 8,500 census tracts nationwide. As a result, commercial growth and real estate development stimulate the economy for each federally designated area as intended.

Unlike a 1031 exchange, the QOZ investor only needs to invest the gain from their sale into the QOZ investment - the investor keeps the basis and uses it however they wish. QOZ rules also require additional capital (typically debt financing) into a project to create the intended economic growth.

Like a 1031 exchange, the investor generally has up to 180 days from recognizing a capital gain to invest in a QOZ project. Day 180 of a failed exchange will be Day 0 for the QOZ timeline, giving the investor nearly six months to invest. Depending on the entity structure owning the real estate, investors might have even longer to invest in a QOZ.

Based on existing legislation, the taxpayer defers their taxable gain through 2026 (payable in 2027). Many investors plan to refinance their project(s) by 2026, providing the liquidity to make the deferred tax payment. While the deferral is attractive, it is only part of the story when it comes to QOZ investments.

The greater incentive is creating a tax-free investment after a ten-year hold period. When disposed of, the QOZ investment's basis equals the sale price. After ten years, capital gains and depreciation recapture are nonexistent when selling QOZ investments. Qualified Opportunity Zone rules amplify the tax advantages rarely offered through most tax strategies.

Staying regionally, New England has 319 census tracts designated as QOZs found in all six states. Massachusetts' 138 QOZs extend from Pittsfield to Provincetown. Defined by census tract, Vermont, New Hampshire, and Maine have larger QOZs in more rural areas (but you will also find QOZs in Portland, ME; Nashua & Manchester, NH; and Burlington, VT.) Finally, Connecticut and Rhode Island have just under a combined 100 QOZs located primarily along either I-91 or I-95. Each state's Economic Development Office (or equivalent) has information on where QOZs are located, along with other online sources.

Professionally managed funds are available to provide the same tax benefits if investors do not want to own the QOZ investment directly.

Thanks to the Internal Revenue Code, real estate investors have some of the most significant advantages out of any taxpayer. Most tax strategies have a long history of deferral. Since policy remains dynamic, new ideas are created, providing different benefits. Even if you are unsuccessful with a 1031 exchange, other opportunities exist to defer taxes and grow your wealth.

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