How Qualified Opportunity Zone Fund Investments May Help Generate Better Outcomes for 1031 Exchange Investors

Both 1031 tax-deferred exchanges ("1031 Exchange") and Qualified Opportunity Zone Funds ("QOZFs") offer investors powerful tax benefits. A 1031 Exchange allows an investor to indefinitely defer capital gains from the sale of business or investment property(ies) (each a "Relinquished Property") through the qualifying acquisition of an interest in another business or investment property(ies) (the "Replacement Property"). However, the rules for 1031 Exchanges under the Internal Revenue Tax Code are strict and failure to comply with these requirements could result in the investor recognizing a tax liability for all or a portion of the gain from the sale of the Relinquished Property. Furthermore, the only way to permanently eliminate any capital gains tax liability when using a 1031 Exchange is through the death of the investor, at which time the tax-basis of the investment is stepped-up to its then fair market value and passed on to the investor's heirs.

Qualified Opportunity Zone Funds only permit deferral of gains until December 31, 2026, but the rules associated with Subchapter Z of the Internal Revenue Code (the "QOZ Rules") are less rigid in their application. The QOZ Rules allow a taxpayer to defer tax on any realized capital gains from the sale of any asset to an unrelated third-party, not just real estate, by reinvesting the gain proceeds into a QOZF. In addition, the QOZ Rules provide an opportunity to exclude any future gains on appreciation resulting from a sale of the QOZF investment if the investor holds its interest in the QOZF for a minimum of 10 years.

Given the differences discussed above, investors often view 1031 Exchanges and QOZFs as mutually exclusive opportunities. While an investor is not able perform a 1031 Exchange into a QOZF, the two strategies can be combined to ensure an investor's current and future needs are addressed appropriately while achieving the maximum possible tax benefits.

COMBINING 1031 EXCHANGES AND QOZFS TO MEET AN INVESTOR'S LONG-TERM LIQUIDITY NEEDS

A 1031 Exchange requires the value of the Replacement Property be equal to or greater than the value of the Relinquished Property. Upon the sale of the Relinquished Property and exchange into the Replacement Property, the investor cannot exercise dominion over any of the sale proceeds. Any cash proceeds retained from the sale of the Relinquished Property is referred to as "Cash Boot" and is subject to taxation. Furthermore, unless the investor passes away, any appreciation of the Replacement Property is subject to capital gains taxation once the property is sold. Therefore, for those investors wishing to defer tax liability through a 1031 Exchange that need or want access to a portion of those proceeds prior to death, a 1031 Exchange alone may not be the most advantageous option.

One potential solution to this common objective is to combine a 1031 exchange and a QOZF investment. Instead of allocating 100% of the proceeds from the sale of a Relinquished Property to a 1031 Exchange, investors can instead allocate a portion of the proceeds to a QOZF. If structured appropriately, 100% of the capital gain tax liability will be deferred. While the gain allocated to the QOZF investment can only be deferred until December 31, 2026, no tax will be due on the appreciation of the QOZF investment if the investor holds their interest for at least 10 years. As a result, the investor can liquidate their interest in a QOZF after 10 years without incurring any tax liability while continuing to defer capital gains tax on the amount allocated to the 1031 exchange. By structuring the transactions in this way, the investor can generate enhanced liquidity and may substantially improve its after-tax return.

1031 Exchange Only Strategy			
	12/31/2021	**12/31/2026**	**12/31/2031**
Equity	$1,000,000	$1,469,328	$2,158,925
Proceeds Not Re-Invested in Subsequent 1031 Exchange	-	-	($1,000,000)
Capital Gains Tax	-	-	($300,000)
Cash to Investor	-	-	($700,000)
Remaining Invested Equity	-	-	$1,158,925
Total After-Tax Value	-	-	$1,858,925
After-Tax Total Return	-	-	185.9%

1031 Exchange and QOZF Investment			
	12/31/2021	**12/31/2026**	**12/31/2031**
1031 Exchange Investment	$675,765	$992,920	$1,458,925
QOZF Investment	$324,235	$476,408	$700,000
Sale of QOZF Investment	-	-	($700,000)
Capital Gains Tax	-	($97,271)	$0
Cash to Investor	-	-	$700,000
Remaining Invested Equity	-	-	$1,458,925
Total After-Tax Value	-	-	$2,158,925
After-Tax Total Return	-	-	196.8%

For example, suppose an investor has $1,000,000 of gain from the sale of their Relinquished Property which had a tax basis of $0 at the time of sale. Their combined state and federal capital gains tax rate is 30% and they are considering a 1031 Exchange and a QOZF that are both expected to generate a pre-tax annual return of 8%. In addition, the investor expects to need access to at least $700,000 after 10 years. For simplicity, we will assume that there was no debt on the Relinquished Property. By splitting the proceeds from the Relinquished Property between the QOZF and the 1031 Exchange, the investor can increase their after-tax return, as illustrated above. In this example, we assume that in the 1031 Exchange only strategy, the investor sells 100% of their interest in the Relinquished Property to achieve their desired liquidity of $700,000 and reinvests the balance in a subsequent 1031 Exchange, thereby continuing to defer tax on such amount.

By splitting the investment between a 1031 Exchange and a QOZF, the investor achieves the same liquidity after 10-years while generating a nearly 11 percentage point increase in their after-tax return. However, it's important to keep in mind that investors pursuing such a strategy will need to ensure that they have sufficient liquidity after December 31, 2026, to pay the capital gains tax that will be due on the portion of their deferred gain invested in the QOZF investment.

MANAGING MORTGAGE BOOT FROM A 1031 EXCHANGE TRANSACTION WITH A QOZF INVESTMENT

1031 Exchanges not only require that all of the proceeds from the sale of a Relinquished Property be invested into a Replacement Property in order to avoid Cash Boot, but also require that the amount of debt on the Replacement Property be equal to or greater than the amount of debt on the Relinquished Property at the time of sale. This can be challenging in rising interest rate environments where buyers may seek lower loan-to-value ratios on Replacement Properties in order to preserve cash flow. As a result, some investors pursuing a 1031 Exchange strategy may find they are unable to achieve the necessary debt replacement levels and will end up with a shortfall, which is referred to as "Mortgage Boot." In these situations, such investors can again benefit from including a QOZF investment in their re-investment strategy since Mortgage Boot would be a capital gain that is eligible for the tax deferral and other benefits of a QOZF.

For example, assume there is an investor that sold its Relinquished Property for $2.0 million and there was a $1.0 million mortgage at the time of sale. We further assume that the investor had $0 of basis in the property at sale and therefore has a $1 million gain on a property with a 50% loan-to-value ratio based on the sale price. When assessing the options for a Replacement Property, the investor is only able to identify an asset with a purchase price of $1.43 million and a $430,000 mortgage, such that their loan-to-value ratio on the replacement property is approximately 30%. If the investor relies on a 1031 Exchange alone, it will incur Mortgage Boot of $570,000, which amount is subject to capital gains tax. To address this issue, the investor could instead invest $570,000 into a QOZF investment and defer its tax liability until December 31, 2026, while generating tax-free growth on the investment in the QOZF if it remains invested for at least 10 years. It is important to note that in such a situation, the investor would have invested 100% of its equity from the sale of the Relinquished Property into the 1031 Exchange transaction. Therefore, the investor would need to contribute additional funds required for the QOZF investment from another source in the amount of capital gain realized and would need to ensure that it has sufficient liquidity to fund the capital gains tax liability that will be due after December 31, 2026. Fortunately, unlike a 1031 Exchange, the funds for a QOZF investment do not need to come directly from the sale of the asset that triggered the gain, which means the investor could use funds from any source to make its investment in the QOZF.

IN SUMMARY

Both 1031 Exchanges and QOZF investments offer powerful tax benefits for investors. However, the strict requirements of a 1031 Exchange only strategy may not meet the needs of some investors. These shortcomings can be effectively managed by adding a QOZF investment to ensure that 100% of the investor's gain from the sale of their property is deferred while also achieving tax-free growth on the portion allocated to the QOZF with enhanced liquidity in the future.

Griffin Capital Company
266 Kansas Street
El Segundo, CA 90245

424.367.4250
www.griffincapital.com

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An investment in a Qualified Opportunity Zone Fund program is subject to various risks, including but not limited to:

- No public market typically exists for the interest of Qualified Opportunity Fund programs. Qualified Opportunity Zone Fund programs are generally not liquid.
- Qualified Opportunity Zone Fund programs typically offer and sell interests pursuant to exemptions to the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular Qualified Opportunity Zone Fund program will be achieved.
- Investments in real estate are subject to varying degrees of risks, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, and inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- The acquisition of interests in a Qualified Opportunity Zone Fund program may not qualify under section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") for tax-deferred exchange treatment.
- The actual amount and timing of distributions paid by Qualified Opportunity Zone Fund programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Fund programs generally depend on tenants for their revenue and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- Disruptions in the financial markets and challenging economics conditions could adversely affect a Qualified Opportunity Zone Fund program.
- Qualified Opportunity Zone Tax Benefits may not be available under state law and some states may impose their own requirements to qualify for the equivalent of the Qualified Opportunity Zone Tax Benefits under state law.

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