HOLLAND&HART LLP

M E M O R A N D U M

November 4, 2019

TO: Duncan Jackson

FROM: Adam M. Cohen

RE: Certain Timing Aspects in 1031 Exchanges and Opportunity Zones

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Under Section 1031, tax on gain can be deferred if the taxpayer reinvests from the sale of qualified property (“relinquished property”) into other qualified property (“replacement property”).[1] Under Section 1400Z-2, tax on gain can be deferred if the taxpayer reinvests from the sale of capital gain property into a qualified opportunity fund (“QOF”). In both regimes, there are time frames within which the reinvestment must occur.

Section 1031(a)(3) contains important timing rules for an exchange under Section 1031. Property is not properly replacement property if it is not identified as replacement property within 45 days after the relinquished property sale. Additionally, property will not be replacement property unless it is received after the earlier of the day which is 180 days after the relinquished property sale or the due date for the taxpayer’s tax return for the year of that sale. The regulations under this provision specifically allow for a “qualified intermediary” (“QI”) to hold proceeds of a relinquished property sale but require the QI to not allow the taxpayer access to these funds until one of these two timing rules has been violated. See Treasury Regulation Section 1.1031(k)-1(g)(4)(ii) and (vi) and -1(g)(6)(ii) and (iii).

Section 1400Z-2(a)(1)(A) contains an important timing rule for an opportunity zone investment. For gain to be deferred, the gain must be invested in the QOF during the 180-day period beginning on the date of the sale or exchange that gave rise to the gain. See also Proposed Treasury Regulation Section 1.1400Z2(a)-1, which also contains special rules relating to this statutory requirement discussed below.

After a relinquished property sale, where the funds have been deposited with a QI, there are a number scenarios where (due to the Section 1031 exchange falling through) the taxpayer might still defer gain by making an investment in a QOF.

1. Failure to Timely Identify: If the taxpayer fails to identify possible replacement property by the 45th day after the relinquished property sale, the QI should provide access to the funds from the relinquished property sale after that 45th day and those funds could be used to invest in the QOF within the 180-day period required by the opportunity zone rules.

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[1] All section references in this memorandum are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

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2. Failure to Timely Acquire Replacement Property. If the taxpayer fails to acquire the replacement property within the 180 days after the relinquished property sale (or the due date of the taxpayer's return), a taxpayer that desires to defer gain by investing in a QOF may wish to consider the following scenarios:

a. Use Other Funds: While Section 1031 generally requires the taxpayer to not have access to the proceeds of the relinquished property and to reinvest those same proceeds in the replacement property, Section 1400Z-2 does not require a taxpayer to use the proceeds of the capital gain property sale to make the QOF investment. As such, while the QI is holding the relinquished property sale proceeds, a taxpayer could use other funds (sufficient in amount to match the capital gain from the property sale) to make the investment in the QOF. These funds could be funds from other sources (including borrowed funds).

b. Use of Other Timing Rules: Certain timing rules under Sections 1031 and 1400Z-2 differ, which could permit a taxpayer that attempts to utilize Section 1031 to use the same funds to make an investment in a QOF.

i. Under Proposed Regulation Section 1.1400Z2(a)-1(b)(2)(iii), the 180-day period for capital gain net income from "section 1231 property" begins on the last day of the taxable year. On the other hand, Section 1031 relies on the date of disposition of the relinquished property. As such, if the relinquished property was "section 1231 property," there may be scenarios where the QI will release the funds due to failure to complete the exchange under Section 1031 and the funds can thereafter be invested in a QOF. For example, if section 1231 property were sold on May 15, 2019 and the proceeds were deposited with a QI and a replacement property was properly identified before June 29, 2019 (i.e., the 45th day) but no replacement property was acquired before November 11, 2019 (i.e., the 180th day), the QOF investment could still be made on December 31, 2019 (or the 179 days after that) with the proceeds released from the QI on November 12, 2019.

ii. Under Proposed Regulation Section 1.1400Z2(a)-1(c)(2)(iii), a partner of a partnership that disposed of capital gain property (and where the partnership itself does not invest in a QOF) may invest in a QOF during the 180-day period beginning on the last day of the partnership's taxable year. So, similar to the "section 1231 property" scenario, if the partnership attempted (but did not complete) an exchange under Section 1031, the partnership might distribute the funds to its partners (after the funds are released from the QI) and allow the partners to make investments into QOFs. For example, if a partnership sold capital gain property on May 15, 2019 and the proceeds were deposited with a QI and (despite proper identification) did not acquire replacement property, after the QI releases the funds on November 12, 2019 to the partnership, the partnership could distribute the funds to the partners and the partners could make an investment in the QOF on December 31, 2019 (or the 179 days after that).