1031 Qualified Intermediary Release of Unused Cash Following 180-Day Exchange Period Would Seem Eligible for Commencement of 180-Day Period to Invest in Qualified Opportunity Fund

Taxpayers who receive 1031 Exchange proceeds from a Qualified Intermediary (QI) should be able to use all or a portion of such remaining cash after the end of the 180-Day Exchange Period to Invest in a Qualified Opportunity Fund ("QOF"). Note, however, that there are series of related points that need to be considered to understand the cash eligible for a QOF investment.

Pursuant to the favorable proposed regulations on this point, taxpayers have 180 days after the capital gain is recognized to invest such capital gain amount into a QOF. Cash that is properly deposited into a QI, when it is reasonable to believe that replacement property will be acquired before the end of the 180-day Exchange Period (the "bona fide intent" requirement), would seem to be eligible for investment through a QOF if such cash was not used to close on the identified replacement property.

The clock for investing in a QOF commences on the day that the gain would have been recognized for federal income tax purposes but for the QOF investment. This is a more favorable approach than the language used in the statute, which references the sale as commencing the clock for investing in a QOF. In the context of a 1031 exchange using a QI, the capital gain is not recognized until the QI releases the exchange proceeds, which would allow the 180-day period for investing in a QOF to commence when the QI releases the unused cash. For example, assume that real property was sold during early November 2018, the relinquished property sale proceeds were properly invested in a QI, and the 180-day Exchange Period ends in early May 2019. In cases where replacement property has been identified that would absorb the QI proceeds but the taxpayer is unable to close on such replacement property within the 180-day Exchange Period, the QI releases the cash on the 181st day. The released cash would seem eligible for investment in a QOF commencing from early May 2019 through the 180-day period ending in early November 2019. Note that the use of two back-to-back 180 day periods followed by a 6-month QOF investment period can be confusing.

At least one comment letter submitted with respect to the QOF proposed regulations requests further clarifying detail regarding the timing of investments in a QOF when capital gain is recognized on the installment sale basis.

A few additional points are connected to this timeline and the amount eligible for investing QI 1031 Exchange proceeds in a QOF:

<u>1. Full Extension Period to Complete Replacement Property Transaction.</u> Besides the 180-day period for investing QI proceeds in a QOF, the QOF has six months to invest the cash amount in an operating company (OpCo) through a QOZ partnership interest, and the OpCo has 31 months to acquire and make substantial improvements to the purchased property. This is a much longer period to purchase and develop property through a 1031 Exchange.

2. Might Avoid Immediate Gain From Mortgage Satisfaction. Consideration should be given to whether any debt amount that was satisfied with 1031 Exchange proceeds can also be available for Opportunity Zone ("OZ") tax benefits through a QOF investment. For example, assume that relinquished property has a $1 million value, a mortgage of $600,000, and a tax basis of $500,000. On the 1031 sale, the $600,000 debt is satisfied with the sale proceeds and the net $400,000 is paid to the QI. If the 1031 exchange was successfully completed, replacement property of at least $1 million would have been purchased and a $600,000 debt would be attached to such replacement property to avoid gain. If replacement property is not purchased, then consideration could be giving to having the taxpayer invest $500,000 (i.e., the capital gain amount) in a QOF. The taxpayer would use the $400,000 net proceeds received from the QI plus an additional $100,000 from whatever source to fully utilize the OZ tax provisions. If only the $400,000 QI proceeds are used to invest in the QOF, then the taxpayer must pay tax on $100,000 capital gain. The relevant point for consideration is the availability of the OZ tax benefits for the gain recognition associated with the debt satisfaction.

3. Importance of Allocating Tax Basis Between Replacement Property Received and the Remaining QI Cash Proceeds. To the extent that a portion of the QI proceeds are used to purchase replacement property and the QI releases the cash balance to the taxpayer, the tax basis of the relinquished property must be allocated between the replacement property and the portion of the cash available for investment in a QOF. Further consideration would be required on the proper tax basis allocation, which is important to determine the potential gain amount and whether all or only a portion of the cash balance is eligible for the OZ tax provisions.

A basic approach would be to allocate all of the tax basis of the relinquished property to the replacement property, but that might not be permissible if the tax basis of the relinquished property exceeds the value of the replacement property. Also, consideration should be given to whether the appropriate tax basis allocation depends on whether the QI disbursement of the cash balance occurs in the same year as or the year following the relinquished property sale.

The proper tax basis to allocate to the replacement property is important because to the extent that any tax basis is allocated to the QI cash balance, then less gain is recognized from the cash disbursement. It is only the recognized gain that is eligible for the QOF post-investment tax free appreciation. If more than the recognized gain is invested in the QOF, then the post-investment tax free appreciation benefit available would be diluted.

4. Expanded Use of QI Proceeds. The OZ provisions allows the QI proceeds to be invested in costs that might not be like-kind real property, such as equipment associated with the building.

5. QI Cash Balance Exceeding $5 Million. If the Section 1031 Exchange straddles two tax years, and the distributed QI cash balance exceed $5 million, consideration needs to be given to whether the Internal Revenue Code Section 453A interest charge rule applies to impose a tax cost on the selling taxpayer for the period between the relinquished property sale date and the release of the QI proceeds, even though the entire cash amount is invested in a QOF.

6. 2020 Receipt of QI Cash Balance Reduces Tax Exclusion Available from 15% to 10%.

If a QI exchange is executed within the second half of 2019 and the QI cash disbursement occurs in 2020, then the maximum tax exclusion for the deferred gain invested in the QOF is 10%, rather than 15%.

The reduction in the maximum tax exclusion can also occur when the QI disburses cash during the second half of 2019 but the QOF investment does not occur until 2020 (within the 180-day period following the QI disbursement).

7. QI Disbursement Within the Past 180 Days. The above discussion applies not only to future QI disbursements of remaining Section 1031 cash proceeds, but also to QI disbursements received within the past 180 days.

This summary highlights a possible opportunity for taxpayers who have executed or will execute Section 1031 exchanges and either have received or will receive a future QI cash disbursement. To the extent that an investment in a designated OZ is attractive, this detail might interest you. There are points that require further consideration, but this is a starting point if all of the designated replacement property in a Section 1031 Exchange is not purchased and there is a QI cash disbursement. Future IRS guidance might address some or all of the above points.

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