

How Qualified Opportunity Zone Funds May Present an Attractive Option For Investors With a Failed 1031 Exchange

Section 1031 of the Internal Revenue Code (“I.R.C.”) provides, among other things, rules by which a taxpayer can defer capital gains upon the sale of real property (the “Relinquished Property”). Generally, when the sale of the Relinquished Property is consummated, the taxpayer must deposit the sales proceeds (the “Exchange Funds”) with a qualified intermediary (the “QI”). If the taxpayer reinvests the entirety of the Exchange Funds in another identified property or properties (the “Replacement Properties”) and the Replacement Properties are encumbered with at least as much debt as the Relinquished Property, the taxpayer will be able to defer the entirety of its capital gain; that is, the taxpayer will not realize either cash or mortgage ‘boot.’

In order to accomplish this objective, the Relinquished Property must be ‘qualified’ (i.e., the property must have been used in a trade or business and not deemed either inventory or dealer property), and the taxpayer must have a bona fide intent to execute a deferred like-kind exchange. Further, the Exchange Funds must have been deposited with the QI subject to a ‘safe-harbored’ arrangement. To comply with the safe-harbor rules, the QI agreement must provide that the taxpayer has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by the QI prior to the end of the exchange period. In this case, the taxpayer will be deemed to have not received either actual or constructive receipt of the Exchange Funds.

Once the Exchange Funds are deposited with the QI, the taxpayer has 45 days in which to identify its prospective Replacement Properties (there are a series of identification rules with which the taxpayer must comply), which transaction must close within 180 days of the receipt by the QI of the Exchange Funds. If the taxpayer fails to identify one or more Replacement Properties within the 45-day period, the QI can return the Exchange Funds to the taxpayer, and, at that time, the capital gain will be deemed realized. If the taxpayer successfully identifies one or more Replacement Properties but fails to consummate the acquisition of such properties, the QI, generally, is bound to retain the Exchange Funds for the full 180-day exchange period (Treasury Regulation Section 1.1031(k)-1(g)(6)). Once those Exchange Funds are returned to the taxpayer at the end of the exchange period, that is the date upon which the capital gain is recognized.

If the prospective tax-deferred exchange fails as a result of either the taxpayer’s inability to: (i) properly identify Replacement Properties during the 45-day identification period; or (ii) close the acquisition of the Replacement Properties within the 180-day exchange period, the taxpayer can still defer its capital gains through an investment in a qualified opportunity zone fund (“QOZF”). Under Subchapter Z of the I.R.C., investing a realized gain into a QOZF allows investors to defer their tax liability with respect to the gain until December 31, 2026. If the investor holds their interest in the QOZF for at least 10 years, then the investor will also be able to elect to have their basis in the QOZF investment stepped up to its fair value upon disposition, thereby eliminating capital gains tax liability with respect to such investment. Therefore, investing capital gains from a failed 1031 Exchange provides investors the opportunity to

still defer their tax liability while also generating tax-free growth on their investment in the QOZF.

Under the Qualified Opportunity Zone rules, when a taxpayer realizes a capital gain (in this case from the sale of real estate), such taxpayer then has 180 days from the date of such realization to invest in a QOZF and obtain the tax benefits associated with QOZFs. For the taxpayer, that 180-day period generally begins on the date on which the eligible gain would be recognized if no QOZ deferral election was made. As such, once the taxpayer receives the Exchange Funds from the QI, the taxpayer then has another 180-day period following such failed exchange to reinvest the sale proceeds from the Relinquished Property into a QOZF. In other words, day 45 or day 180 of a failed 1031 exchange can be day 1 of 180 for the window to make an eligible QOZF investment.

The statements included herein are not intended to provide tax advice to the taxpayer and we recommend that the taxpayer seek its own advice from its tax advisors.



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IMPORTANT RISK FACTORS

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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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