To Defer or Postpone, That is the Question

Exchange Over Two Tax Years May Be Treated as an Installment Sale

1031 Knowledge

In a delayed exchange transaction structured to satisfy the requirements of IRC Section1031, a taxpayer has up to 180-calendar days to acquire like-kind replacement property measured from the day the relinquished property is sold. Once initiated, the delayed exchange may be successfully completed (resulting in complete tax deferral), partially completed (resulting in recognition of some capital gain) or it may fail if no like-kind replacement real property is acquired (resulting in the recognition of all capital gain generated by the sale). If the exchange begins in one tax year and extends into the subsequent tax year, the question arises whether the gain realized on the sale is recognized in the year in which the relinquished property was sold or in the subsequent year in which the taxpayer received the cash sale proceeds from the qualified intermediary. In a perfect world, the gain would be recognized in the subsequent year when the proceeds were actually received by the taxpayer. In many cases, this turns out to be wholly or partially true.

The regulations under Section 1031 treat a tax-deferred exchange as an installment sale to the extent that the taxpayer receives cash or other non-like-kind property (known as "boot") in a subsequent tax year. See Treas. Reg §1.1031(k)-1(j)(2). This can occur if the taxpayer buys replacement property with a value lower than the relinquished property, obtains excess financing in connection with the purchase of replacement property or fails to acquire any replacement property leaving cash boot in the hands of the qualified intermediary. In all cases, the cash received from the qualified intermediary at the end of the exchange is treated as a payment in the year it is actually received by the taxpayer for purposes of the §453 installment sale reporting rules rather than in the year the relinquished property was sold. On the other hand, any mortgage debt that is paid off on the sale of the relinquished property is treated as a payment in the year of the sale to the extent the taxpayer does not incur an offsetting liability in its acquisition of replacement property. Nevertheless, the tax deferral afforded by the coordination of 1031 and the installment reporting rules under §453 can produce a significant advantage where gain must be recognized as the result of a wholly or partially failed exchange; sort of a heads I win, tails you lose tax benefit in favor of the taxpayer.

AN ILLUSTRATION STRADDLING 2023/2024 TAX YEARS

For example, suppose a taxpayer initiates a 1031 exchange with a qualified intermediary by transferring

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investment property worth $900,000 with no mortgage debt. Pursuant to a valid exchange agreement, the taxpayer's qualified intermediary completes the relinquished property sale on July 28, 2023. On January 5, 2024, the qualified intermediary acquires a like-kind replacement property with a fair market value of $600,000 (using $600,000 of the exchange proceeds) and transfers the replacement property to the taxpayer. No other replacement properties are acquired in the exchange, and on January 25, 2024 (the 181st day), the qualified intermediary transfers the remaining $300,000 in cash boot to the taxpayer. In this example, the taxpayer has completed a partial §1031 exchange and will recognize gain to the extent of the $300,000 payment received at the end of the exchange. Under the installment sale reporting rules, the gain is recognized in the year of the payment, 2024. Consequently, the capital gain is reported on the taxpayer's tax return for 2024 (filed in 2025) and not on the 2023 tax return for the year in which the gain was realized.

BONA FIDE INTENT

Despite the tax deferral opportunity discussed above, a taxpayer should not engage a qualified intermediary for the principal purpose of deferring tax under §453. In the case of a delayed exchange, §1031 is inapplicable unless the taxpayer has a "bona fide intent" to complete the exchange. A taxpayer has a bona fide intent if, based upon all facts and circumstances at the beginning of the exchange, it is reasonable to believe that like-kind replacement property will be acquired during the exchange period. The taxpayer's intent, however, need not be pure and there is no requirement that the exchange be wholly or partially successful. For example, in Smalley v. Commissioner, 116 TC 29, 2001, a case involving a failed exchange which straddled two tax years, the Tax Court upheld the IRS's determination that the replacement property acquired by the taxpayer on the sale of the relinquished property should be recognized in the year of the sale. The Tax Court held, however, that the taxpayer was entitled to installment sale treatment because he engaged in the transaction with the requisite intent, notwithstanding his failure to acquire like-kind property. In this case, the taxpayer's bona fide intent made the difference, at least as to the deferral afforded under §453.

An investor contemplating an exchange in which there may be some cash boot should review their situation with competent tax and/or legal advisors.

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