

When to Pay the Piper (and How Much Will He Charge)?

1031

Knowledge

A 1031 exchange permits taxpayers the opportunity to defer tax on capital gains indefinitely. To some extent, the benefit of tax-deferral depends on tax rates that apply in the future when there is a taxable disposition of the investment property. Obviously, if tax rates increase significantly, one might benefit from paying taxes today at lower rates.

The federal tax rate on long-term capital gains is currently fifteen percent (15%) or twenty percent (20%), depending on the taxpayer's taxable income. In addition, the national health care reform legislation imposes a 3.8% tax on certain net investment income. Thus, for some higher-income taxpayers, the effective rate on long-term capital gains is 23.8% (not including state taxes or the 25% tax rate on depreciation recapture). Given the inability of Democrats and Republicans in Congress to agree on almost any significant legislation in recent years, it is anybody's guess what rates will be in the future. Accordingly, some taxpayers and their advisors have determined that they should recognize capital gains now and lock in the current capital gains rate. Where tax-deferral is otherwise possible, a decision to pay taxes now constitutes a simple wager that capital gains rates will increase even more in the future.

One might reasonably make that bet and take the risk that Congress will continue to extend the current rate, but is that actually necessary? For some taxpayers, there is a better solution. What if you could sell investment property in the latter half of 2019 and, in 2020 choose whether to: (i) pay the capital gains tax at the 2019 rate, (ii) pay the tax in 2020 (if the capital gain tax rate is reduced in 2020), or (iii) defer the tax indefinitely with a tax-deferred exchange under Internal Revenue Code Section 1031? For some well-positioned taxpayers, such a strategy is possible.

Section 1031 permits a taxpayer to sell appreciated real property and to acquire replacement real property in a deferred exchange that extends from one tax year to the next. A taxpayer generally has 180 days to complete the 1031 exchange. For example, if qualifying investment property is sold in October 2019, the taxpayer must acquire like-kind replacement property by March of 2020. If no replacement property is acquired by the 180th calendar day in 2020, then the taxpayer generally recognizes some or all of the gain in 2019, when sale proceeds are received from the qualified intermediary. By default, the "installment sale" feature of Section 1031 effectively pushes the taxable gain into the following tax year (in this case, 2020). This could be good or bad. If tax rates do not increase, the incomplete 1031 exchange pushes the taxable event forward allowing for some tax-deferral – a net benefit. If rates increase, a higher 2020 tax may wipe out the benefit of the short tax-deferral. As it turns out, however, the taxpayer has a choice whether to pay the tax in 2019 or 2020, at the then applicable rates. In other words, there is no requirement that the taxpayer pay the tax at the 2019 rate if rates actually do increase in 2020.

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Treasury Regulation 1.1031(k)-1(j) provides that the installment sale rules apply to the obligation of a qualified intermediary to pay over sales proceeds held by the qualified intermediary under an exchange agreement. The installment sale rules are contained in Internal Revenue Code Section 453 and 453A. Those provisions generally provide that a taxpayer recognizes gain on a sale of property in the year the payments are received. Under the installment method, taxable gain is reported over the term of the installment payments, as payments are received. Accordingly, if a taxpayer sells an investment property in October 2019 for \$1,000,000 with a basis of \$500,000, and the 180-day exchange period elapses without the taxpayer finding a replacement property, the taxpayer would recognize the \$500,000 gain in 2020 provided that no replacement property was acquired at the end of the exchange. This would be the “default” treatment under Section 453. Section 453, however, permits the taxpayer to elect out of the installment method by timely filing a tax return (including extensions) for the year in which the relinquished property sale was closed. This is true even if the taxpayer initiated a 1031 exchange with a qualified intermediary. See e.g., PLR 200813019. Going back to our example above, the taxpayer could elect to report the gain in 2019 if rates are higher in 2020 or could take advantage of deferral into 2020 if capital gain rates remain the same or decline. Lastly, the taxpayer might simply complete a 1031 exchange and defer the capital gains tax indefinitely.

A taxpayer engaging in a 1031 exchange must have the intent to acquire like-kind property at the inception of the exchange. Thus, the above discussion is not intended to encourage a taxpayer to initiate a 1031 exchange just to hedge against the potential for higher capital gains tax rates in 2020. But in close cases, where the taxpayer might be inclined to sell in 2019 in order to avoid the risk that rates will be higher in 2020, it is important to realize that a 1031 exchange permits far greater flexibility to respond to changes than a simple, bare wager that rates will increase enough to eliminate the benefits of tax-deferral.

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