API Legal and Tax Update

When to Pay the Piper (and how much will he charge)?

A tax-deferred exchange permits investors 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 for most taxpayers is currently fifteen percent (15%). If Congress fails to extend that rate, then the tax rate on long-term capital gains will increase to twenty percent (20%) in 2013. In addition, the national health care reform legislation that became law in March, 2010, imposes a new 3.8% tax on certain investment income beginning in 2013. Thus, for some higher income taxpayers, the effective rate on long-term capital gains will increase to 23.8% (not including State taxes). 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 next year. Accordingly, some taxpayers and their advisors have determined that they should recognize capital gains in 2012, where possible, to lock in the current low capital gains rate. Where tax-deferral is otherwise possible, a decision to pay tax now constitutes a simple wager that capital gains rates will increase in the future.

One might reasonably make that bet and take the risk that Congress will extend the current rate and eliminate the Medicare tax on gains, but is that actually necessary? For some taxpayers, there is a better solution. What if you could sell investment property in 2012 and, in 2013 choose whether to: (i) pay the capital gains tax in 2013 at the 2012 rate, (ii) pay the tax in 2013 (if the favorable rate remains in 2013), 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 property and to acquire replacement property in a deferred exchange that extends from one tax year to the next. A taxpayer generally has 180 days to complete the exchange. For example, if qualifying investment property is sold in October, 2012, the taxpayer must acquire like-kind replacement property by March of 2013. If no replacement property is acquired by the 180th calendar day in 2013, then the taxpayer generally recognizes some or all of the gain in 2013, 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, 2013). 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, the higher 2013 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 2012 or 2013, at the then applicable rates. In other words, there is no requirement that the taxpayer pay the tax at the higher 2013 rate if rates actually do increase.

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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 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 ratably over the term of the installment payments, as payments are received. Accordingly, if an exchanger sells an investment property in October 2012 for $1,000,0000 with a basis of $500,000, and the 180-day exchange period elapses without the exchanger finding a replacement property, the taxpayer would recognize the $500,000 gain in 2013 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 exchanger initiated a tax-deferred 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 2012 if rates were higher in 2013, or could take advantage of deferral into 2013 if capital gains rates remain the same or decline in 2013. Lastly, the taxpayer might simply complete the exchange and defer the capital gains tax indefinitely.

A taxpayer engaging in a tax-deferred 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 tax-deferred exchange just to hedge against the potential for higher capital gains tax rates in 2013. But in close cases, where the taxpayer might be inclined to sell in 2012 in order to avoid the risk that rates will be higher in 2013, it is important to realize that a tax-deferred 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.

There is, of course, the old adage familiar to real estate professionals, "swap until you drop." The same old rules remain true even when there is uncertainty as to future tax rates.

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