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Tax filings for non-resident sellers, foreign taxpayers and late-year exchangers

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Deferring the payment of taxes by completing an IRC section 1031 - tax deferred exchange is like scoring a home run against those dreaded capital gains, but you must cover all your bases upfront and on time - one mis-step and the exchange game is over. Several scenarios require formal tax exemptions prior to the transaction.

Non-Resident Sellers

More and more, individual states are imposing a withholding tax on the sale of real property by taxpayers who are not legal residents of the particular state where the property is located. This tax is often a percentage of the sales price, which varies from state to state, and the settlement agent is required to receive that money from the closing and forward it to the proper authority upon transfer of the property.

However, investors may still use the 1031 exchange to their advantage by applying for and receiving a non-resident withholding exemption. Among those states requiring non-resident withholding, such as Maine, Rhode Island and Vermont, the exemption must be received prior to the relinquished property transfer. Non-residents selling property in New York would file and claim their exemption at the closing using form IT-2663. Each of the state-specific forms and requirements are available by contacting IPX1031 or the particular revenue service division.

Foreign Taxpayers

Any foreign person disposing of property in the United States is subject to a withholding tax, as well. Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), the transferee is required to withhold 10% of the sales price and remit this amount to the IRS within 20 days of the property transfer. This presents a problem for foreign taxpayers wishing to participate in a 1031 exchange, for although the taxpayer may apply for a withholding exemption, the 10% must be held in escrow until the exemption is granted. Now the ability for the taxpayer to roll that amount through a tax-deferred exchange in a timely manner may be in jeopardy.

The reality is that issuance of FIRPTA exemptions may take longer than the six-month acquisition period IRC section 1031 allows. This greatly impacts the taxpayer's ability to utilize those held funds for the exchange, because the exemption would not be granted in time for the remaining 10% to be available for use in the replacement property purchase. If exemption is approved and the withheld funds returned to the taxpayer after the end of the exchange, those funds are considered boot - taxable gain.

The use of a 1031 declaration and notice to the transferee indicating the foreign taxpayer is not required to recognize any gain or loss based on their intention to use those funds to complete a 1031 exchange is only reliable if the seller completes a simultaneous exchange, selling and buying property on the same day, and receives no cash or mortgage boot, which often is not the case.

Consequently, alternative strategies for funding the 10% withholding or early filing and receipt of the exemption is a must for foreign taxpayers wishing to affect a tax deferred exchange and avoid the possibility of that amount being treated as boot.

Fall Exchangers

Take Notice

One of the key 1031 exchange deadlines is that the exchanger/taxpayer must purchase the replacement property 180 days following the date on which the first relinquished property was transferred, or the due date for the exchanger's tax return for the year the relinquished property was transferred, whichever is earlier. Since taxpayers must report their exchange on the tax return for the year in which the exchange transaction began, this brings a note of caution to those who relinquish property during the upcoming fall season.

Adhering to this guideline, an exchanger relinquishing property after October 18 has less than 180 days in which to complete the exchange, assuming the due date of the exchanger's tax return filing is April 15 (advisors should clarify whether calendar or fiscal year returns are filed). The remedy for those who cannot complete the replacement purchase in the lesser-allotted time is to file an extension to their tax return deadline in order to take advantage of the full 180 day time period.

Once the exchange has concluded, IRS Form 8824, like-kind exchanges, must be prepared to reflect the transactions.

Failure to follow proper tax exemption and filing procedures may result in missed opportunities and could possibly nullify the entire transaction. For these and other issues, consulting with a well informed Intermediary, in conjunction with legal and/or tax counsel, should always be an integral part of any taxpayer's agenda.

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