1031 Exchanges: To defer in 2019 or postpone to 2020? - by Lynne Bagby

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New England real estate investors who sell investment property and desire Section 1031 tax deferral sometimes question if they should close this year or postpone until 2020. One of the factors to consider is that 1031 exchanges straddling two tax years may be treated as an "installment sale" under Section 453 which provides a couple of options.

In a delayed exchange structured to satisfy the 1031 exchange requirements, a taxpayer has up to

180-calendar days to acquire like-kind replacement property from the day the relinquished property sales closes. Once initiated, the delayed exchange may be successfully completed (achieving 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 1031 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 (QI.) In a perfect world, the gain would be recognized in the subsequent year when the exchange proceeds are actually received by the taxpayer. In many cases, this turns out to be wholly or partially true.

The treasury regulations 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 2019/2020

Suppose a taxpayer initiates a 1031 exchange with a QI by transferring investment property worth $900,000 with no mortgage debt. Pursuant to a valid exchange agreement, the taxpayer's QI completes the relinquished property sale on November 28, 2019. On January 25, 2020, the QI acquires a like-kind replacement property with a fair market value of $600,000 and transfers the replacement property to the taxpayer together with the remaining $300,000 in cash boot. In this example, the taxpayer has completed a partial 1031 exchange and will recognize gain on the $300,000 received at the end of the exchange. Under the installment sale reporting rules, the gain is recognized in the year of receipt, 2020. Consequently, the capital gain is reported on the taxpayer's tax return for 2020 (filed in 2021) and not on the 2019 tax return for the year in which the gain associated with the relinquished property sale was realized.

Bona Fide Intent

A taxpayer should not engage a QI for the principal purpose of deferring tax under §453. Section 1031 is inapplicable unless the taxpayer has a "bona fide intent" to acquire replacement property and complete the 1031 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 180-day 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 should be recognized in the year of the sale. The Tax Court held, however, that the taxpayer was entitled to §453 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 under §453.

New England investors contemplating a 1031 exchange in which there may be some cash boot should review their situation with competent tax and/or legal advisors.

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