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Eagerly awaiting a Covid-19 extension for 1031 Exchanges - by Pajonas, Scheriff and Walther of Legal 1031 Exchange Services

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A 1031 exchange is a tax strategy used by real estate investors to defer capital gains tax recognized upon the sale of real estate. In order to successfully complete a 1031 exchange, the taxpayer must purchase business or investment real estate within 180-days of the original sale and identify these replacement properties within 45-days of the original sale.

The 1031 exchange rules only allow for extensions of these timelines in very limited circumstances including a presidentially declared disaster that affects parties involved in an exchange. In general, there are several steps required to extend the 1031 exchange deadlines: a Presidential Disaster must be declared, FEMA has to specify that a disaster area is eligible for individual assistance, and the IRS must provide additional guidance in the form of a notice of extension. The IRS has not yet released guidance regarding how the COVID-19 pandemic affects taxpayers currently involved in a 1031 exchange.

Currently, FEMA has updated their map, to show individual assistance for all of New York, and for several other states, including New Jersey, California, and Washington. Accordingly, the IRS should take the next step and issue a notice of extension, as the criteria for doing so has been met. This guidance is the much-needed final piece to provide some peace of mind to taxpayers currently involved in an exchange. The Federation of Exchange Accommodators (qualified intermediary trade group) and numerous real estate trade associations, are pushing the Treasury Department to issue the required notices and sent a letter to Treasury Secretary Steven Mnuchin on March 23, 2020. The real estate industry is still waiting for a response.

Historically, extensions are for 120-days; both for the 45 ID period (if the exchange is still within the ID period) and the 180-day period in which to purchase replacement property. To qualify, the taxpayer must be an “affected taxpayer,” which means that the disaster’s effect on the area designated by FEMA complicated their exchange. The rules for extensions are in IRS Rev. Proc. 2018-58, Section 17, which explains who might be an “affected taxpayer.” This guidance does not, in itself, provide for extensions. Examples of situations where taxpayers may be eligible for extensions include, but are not limited to:

- Relinquished (sale) or Replacement (purchase) property is located in a designated disaster area;
- The settlement attorney’s office (or title/escrow company, qualified intermediary, lender, financial institution) is within a disaster area (even though the buyer and seller aren’t) and this complicates the transaction – i.e. parties cannot travel due to quarantine, or the transaction cannot be completed remotely;
- A lender financing the purchase of real estate decides to permanently or temporarily decline funding because insurance is not available due to the disaster;
- The title insurance company is not able to provide the required title policy necessary to settle or close the transaction within the deadlines, due to the disaster.

What if you or your client is personally affected by CV-19? The rules specify that if a party or their employee is “injured, killed, or missing” due to the disaster, they qualify for an extension of the 1031 deadlines. Currently, if a party's health is affected by the virus, it is not clear under what circumstances they would qualify as “injured” or not, due to the disaster.

How does the extension work? It depends on where the taxpayer is in the exchange timeline. If a taxpayer is still within the 45-day ID period they would, historically, receive an additional 120 days to identify, plus an extra 120 days, in addition to the 180-days, in order to close (for a total of 300 days). For example, if the IRS Notice were to designate a date that the disaster took effect for a specified area - and the taxpayer started their exchange (i.e. Feb. 5th) prior to the disaster date (i.e. March 20th), and their 45th day fell afterward (i.e. March 21st), they would qualify for an extension.

However, historically, if the 45-day deadline has passed, the taxpayer could only get to reopen their ID if their property is “affected” by the presidentially declared disaster. For example, did the tornado or wildfire, damage the building the taxpayer was going to buy? The corona virus isn’t going to “damage” any properties, but it could temporarily contaminate them, or make them subject to a mandatory quarantine order, causing them to close. Would the IRS consider this an “affected property?” It remains to be seen.

This question has left many professionals wondering if the IRS will do something different for this extension, due to the unique type of disaster, but historically this is how the 45-day rule would be affected by an extension. Taxpayers past their 45-day ID period when the disaster was announced would traditionally NOT get additional time. In our current situation, this limitation presents an issue because those structuring their transaction as a 1031 exchange may second guess the replacement properties that they identified because of changes in net operating income due to current tenants’ inability to pay rent. The struggle is that when the rules were written, it appears that they did not consider a disaster of the type we are currently experiencing; one that would shut down businesses but not physically damage the real estate.

We encourage everyone involved in a 1031 exchange to be patient. Although there is a decent chance an extension will be issued, the most conservative approach is for taxpayers to proceed as if no extension will be provided. The Treasury Department is no doubt dealing with the larger economic impact of Covid-19 and the hope is that they will turn their focus to this issue in a timely fashion.

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Legal 1031 Exchange Services, LLC is a Qualified Intermediary for IRC §1031 tax deferred exchanges. A Qualified Intermediary is an independent third party to the transaction whose function is to structure the exchange, as well as to act as the independent escrow agent for the exchange funds. While a Qualified Intermediary may not provide tax or legal advice we can, however, provide information and assistance.

Legal 1031 Exchange Services, LLC prides itself on providing the support and information you need to complete your 1031 exchange transaction. Our experience enables us to handle many different types of exchanges. Legal 1031 is committed to giving personalized service to every client, but especially those who are new to 1031 exchanges.

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