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Tax straddles and the pros and cons of an exchange spanning two tax years - by Michele Fitzpatrick

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In a typical 1031 Exchange, real estate investors are able to defer taxable gains under Internal Revenue Code (IRC) Section 1031. If a taxpayer engages in a like-kind exchange of property, which is a tax-deferred transaction in which one investment property is exchanged for another of the same type, they may defer recognition of any taxable gain or loss realized on the exchange.

A “tax-straddle” situation occurs when a taxpayer initiates a 1031 Exchange near the end of their tax year and it extends into the following year. When the sale of the relinquished property and the completion of the exchange span two different tax years, any gain recognized attributable to a partial or failed exchange is reported to the IRS under the installment method, where at least one payment is received after the tax year of the sale.

If the exchange fails, however, and the taxpayer receives cash or other non-like-kind property, the taxpayer may be subject to immediate recognition of any gain or loss realized on the exchange. If the taxpayer fails to complete their Section 1031 Exchange, the installment method can allow them to defer paying capital gain taxes from the sale of an investment property.

A qualified intermediary (QI), holds the proceeds from the sale during the period before the replacement property is purchased. In the case of a tax straddle, the proceeds from the sale would not be released from the QI to the taxpayer until the subsequent year. Tax straddles can offer the benefit of a short-term deferral of taxable gain into the next tax year, serving as a stopgap for failed or partially taxable 1031 Exchanges.

Even if you’re considering selling investment property during the second half of the year and are unsure about finding a replacement, a 1031 Exchange still might be worth initiating. Even if the exchange fails, tax straddling could buy you another year before the tax bill comes due – giving you time to plan, reinvest elsewhere, or simply manage your cash flow.

It’s important to understand that the IRS does not penalize Exchangers for attempting a 1031 Exchange that ultimately fails. What matters is that the exchange was initiated with a bona fide intent to defer tax by reinvesting.

Tax straddles are most beneficial in the following situations:

Fully Failed Exchange: If the taxpayer has a high basis and relatively low debt and starts an exchange in year one that is fully abandoned in year two, most of the debt relieved can be sheltered by basis and the taxable gain from the cash received is not realized recognized until year two.

Relinquished Property with No Debt and All Equity: If the taxpayer completes a partial exchange or fully fails an exchange in year two, an all-cash scenario is ideal because there is no debt relieved upon sale and taxable gain is not realized recognized until they receive cash from a QI.

Partial Exchange with Cash Boot: If the taxpayer completes a partial exchange but replaces all or most of the debt and they receive cash boot in year two, they receive the benefit of reporting the related income taxable gain in year two.

Tax straddles are less beneficial in the following situations:

Individual/Partner’s Share of Debt is in excess of their available basis: Although it is not common, this situation can create tax liability in year one. This applies to both a fully failed exchange or in a partial exchange where debt is not completely replaced.

Transactions where over $5,000,000 in gain is deferred into year two: For large transactions – specifically, installment sales or straddles with over $5 million in gain deferred to a subsequent year – the taxpayer is required to pay interest on the deferred tax amount from one year to the next (IRC §453A(c)).

With a tax straddle situation, as with all 1031 Exchanges, the quality and experience of your financial team is critical and can make the difference between a minor financial event and a major tax liability misstep. As always, you should consult with a tax professional to ensure proper reporting and to maximize your benefits, while minimizing your tax liabilities.

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