

# TO DEFER OR POSTPONE, THAT IS THE QUESTION

## "EXCHANGES OVER TWO TAX YEARS MAY BE TREATED AS AN INSTALLMENT SALE"



### Compliments of

In a delayed exchange transaction structured to satisfy the requirements of §1031, an exchanger has up to 180 calendar days to acquire like-kind replacement property measured from the day the relinquished property is sold. Once initiated, the delayed exchange may be successfully completed (resulting in complete tax deferral), partially completed (resulting in recognition of some capital gain) or it may fail if no like-kind replacement property is acquired (resulting in the recognition of all capital gain generated by the sale). If the 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 exchanger received the cash sale proceeds from the qualified intermediary. In a perfect world, gain would be recognized in the subsequent year when the proceeds were actually received by the exchanger. In many cases, this turns out to be wholly or partially true.

The Regulations under §1031 treat a tax deferred exchange as an installment sale to the extent that the exchanger 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 happen if the exchanger 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 exchanger 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 exchanger 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 exchanger.

#### AN ILLUSTRATION STRADDLING 2009/2010 TAX YEARS

For example, suppose an exchanger initiates a tax deferred exchange with a qualified intermediary by transferring investment property worth \$900,000 with no mortgage debt. Pursuant to a valid exchange agreement, the exchanger's qualified intermediary completes the relinquished property sale on July 28, 2009. On January 5, 2010, the qualified intermediary acquires a like-kind replacement property with a fair market value of \$600,000 and transfers the replacement property to the exchanger together with the remaining \$300,000 in cash boot. In this example, the exchanger has completed a partial §1031 exchange and will recognize gain to the extent of the \$300,000 payment received at the end of the exchange. Under the installment sale reporting rules, gain is recognized in the year of the payment, 2010. Consequently, the capital gain is reported on the exchanger's tax return for 2010 (filed in 2011) and not on the 2009 return for the year in which the gain was realized.

#### BONA FIDE INTENT

Despite the tax deferral opportunity discussed above, an exchanger should not engage a qualified intermediary for the principal purpose of deferring tax under §453. In the case of a delayed exchange, §1031 is inapplicable unless the exchanger has a "bona fide intent" to complete the exchange. An exchanger has a bona fide intent if, based upon all the fact and circumstances at the beginning of the exchange, it is reasonable to believe that like-kind replacement property will be acquired during the exchange period. The exchanger'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 that straddled two tax years, the Tax Court upheld the IRS's determination that the replacement property acquired by the exchanger was not like-kind. On that basis, the IRS argued that the exchanger's gain on the sale of the relinquished property should be recognized in the year of the sale. The Tax Court held, however, that the exchanger was entitled to 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 exchanger's bona fide intent made the difference, at least as to the deferral afforded under §453.

An investor contemplating an exchange in which there may be some cash boot should review their situation with competent tax and/or legal advisors.



**ASSET PRESERVATION**  
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

Template # 128

*Asset Preservation, Inc. does not give tax or legal advice. The information contained herein should not be relied upon as a substitute for tax or legal advice obtained from a competent tax and/or legal advisor.*