# Failure of Your 1031 Exchange May Be A Win At Tax Time Straddling a Tax Year

The terms of a normal exchange agreement call for the exchange period to end on or before the end of the expiration of midnight on the earlier of (i) the 180th day after the date upon which the Exchangor has transferred the Relinquished Property or (ii) the due date (including extensions actually obtained) for Exchangor's tax return for the taxable year in which the transfer of the Relinquished Property occurs. This time of year brings questions from many Exchangor's wishing to defer tax but also wondering if they have funds left that have not been used to purchase replacement property when will the tax be due on those funds.

Lets say that your exchange Relinquished Property closed any time after July 5, 2010 this date means that you have the potential of straddling a tax year with your exchange. In the case of closing on July 5, 2010 your 180th day would be January 1, 2011. If you made a valid identification of replacement property during your 45 day identification period but you did not utilize all of your exchange proceeds to purchase replacement property or your exchange failed then you would receive the balance of your proceeds on January 2, 2011.

**Ask your tax consultant if you can report the proceeds under the IRC Section 453 (Installment Sales Basis). If you do decide to report on an Installment Sales Basis then you could potentially pay the taxes in 2012.**

Qualifications for a 453 Installment Sale are numerous. Considerations for the 1031 Exchange are:

Did you have a bona-fide intent to participate in a 1031 Exchange at the outset of the sale of your relinquished property. Of course, as with any tax planning, there are certain caveats: you must pass the "bona fide" intent requirements of the Code. A taxpayer is treated as having a bona fide intent only if it is reasonable to believe, based on the facts and circumstances present, that like kind property will be acquired before the end of the exchange period (the 180th day). Partnerships may be required to report the gain in the year the property was sold (due to Revenue Procedure 2003- 56) and quarterly tax payers need to coordinate this approach with their CPA as the Estimate Payment Rule may dilute or completely eliminate the tax straddling benefit.

Section 453A further provides that (1) where an obligation is outstanding as of the close of a taxable year and (2) the face amount of all such obligations held by the taxpayer that rose during, and are outstanding as of the close of, such taxable year, exceeds $5 million, interest must be paid on the deferred tax liability with respect to such obligations.

As with any tax strategy. one size fits all approach does not work for everyone. Each taxpayer should strategize with their independent CPA or tax advisor to determine what their best approach would be.

Consider the following scenarios:

Mr. and Mrs. Jones sell a residential rental property for $350,000 on December 1, 2010 and enter into a 1031 exchange whereby their proceeds are transferred to the QI and placed into a qualified escrow account. The Jones' then set out to find replacement property. They contact their broker and view several properties and write offers on two properties. Both offers are rejected, subsequently no identification is made and their funds are disbursed to them on January 16, 2011 (day 46). The property which was sold to generate the $350,000 will be reportable on the 2010 tax return but the recognized gain will be reported on the 2011 return using the installment sale provisions of the IRS.

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