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Are You Starting a 1031 Exchange Late in 2012?

You may need to file for an extension for your tax return

Internal Revenue Code Section 1031 allows a taxpayer to dispose of real estate (the "relinquished property") and acquire replacement real estate (the "replacement property") on a tax deferred basis. This is referred to as a "1031 exchange" or a "like-kind exchange."

Filing your tax return ends the exchange period

A 1031 exchange is reported on the tax return for the tax year in which the relinquished property is transferred (using a specific form that requires the input of detailed information). The taxpayer must acquire all replacement property by the earlier of 180 days after the closing date of the relinquished property (the closing date is counted as day 1), or the due date, including extensions, of the tax return on which the sale of the relinquished property is reported. This means that for 1031 exchanges where the relinquished property closes late in the year (from approximately October 15 until the end of the year), the taxpayer must get an extension of the tax return filing deadline in order to benefit from the full 180-day exchange period.

For example, if the relinquished property closes on December 1, 2012, and an individual does not get an extension for filing his tax return, the taxpayer will only have until approximately April 15, 2013 to acquire all replacement properties. If the taxpayer gets an extension, however, he will have until approximately May 30, 2013 to acquire all replacement properties.

Once a tax return is filed, it cannot be amended to include the exchange or to obtain an extension of time to complete the exchange. If the exchange is incomplete, the sale of the relinquished property will need to be reported as a taxable event.

When you want the exchange period to expire early

Sometimes exchanges are started late in the year and completed the next year before April 15. The taxpayer may have identified three replacement properties and acquired one, but there is still some available cash from the sale of the relinquished property that is being held by the qualified intermediary. The qualified intermediary must continue to hold the remaining cash until the earlier of when all replacement properties are acquired, or the end of the exchange period. In order to get his cash early, an individual taxpayer can decide not to file an extension. In that case, the exchange period will end on April 15, and the qualified intermediary may release the remaining exchange funds on April 16. If the taxpayer were to get an extension of the filing date of his tax return, the intermediary would be required to hold the remaining exchange funds until the earlier of the expiration of the 180-day exchange period or the extended due date for the tax return.

Reporting an incomplete or failed exchange
Sometimes a taxpayer starts an exchange but is unable to acquire any replacement property. In other instances, a taxpayer may acquire some replacement property but have left over cash (referred to as "boot") which will be taxable. In both of those situations, if the taxpayer starts the exchange in one year and receives the left over cash in the following year, the boot received can be treated like an installment sale. In other words, any cash received in the second year can be reported in that year rather than the year the relinquished property closed.

Additional rules
Very detailed and complex rules may apply to your particular 1031 exchange transaction. Additional filing requirements may apply to certain specialized transactions such as reverse exchanges or multi-asset exchanges. It is important that you consult your attorney and accountant prior to commencing, and at all stages during, the 1031 exchange. Minor inadvertent actions that do not comply with the exact requirements of Section 1031 may result in the taxpayer being subject to tax on all or a portion of the gain inherent in the disposition of the relinquished property, without necessarily receiving any cash with which to pay the tax.

If you have questions on this or any Real Estate issue you may contact your Thompson Coburn attorney or one of the Intellectual Property attorneys listed below:

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