

## **FINDING A TAX BREAK IN A FAILED LIKE-KIND EXCHANGE**

*You may be able to push your gain into next year.*

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**1031 exchanges can prove very useful.** Every day, real estate investors exchange out of investment or business properties for “like-kind” properties while deferring capital gains - all thanks to Internal Revenue Code Section 1031. The exchanger, of course, is restricted from immediately getting the sale proceeds; they go into an escrow fund maintained by a qualified intermediary. (If you take control of the proceeds, you have a sale, not a like-kind exchange.)<sup>1,2</sup>

**However, 1031 exchanges sometimes fail.** A suitable replacement property must be identified within a 45-day period, and the exchange must be made within a 180-day period. If either test is unmet, the exchange has failed and the investor who sought to make the exchange will receive the proceeds (a capital gain) from the qualified intermediary.<sup>1,3</sup>

**But if a New Year is approaching, another tax break is possible.** If the 45-day identification period starts on, say, December 1, and ends in January without any potential replacement property identified, then you will get the proceeds on the sale of your relinquished property in January when that 45-day window shuts. But under current tax law, you have the option of reporting the sale on this year’s federal return and recognizing the gain on next year’s federal return.

The IRS is giving you a break here. When a failed exchange coincides with the end of a year and the beginning of another, you have the option of employing the installment sale method in IRC Section 453 to recognize gains from the sale in the coming tax year rather than the current one.<sup>3</sup>

Is that worth it? It depends on your tax picture. It might be quite beneficial. On the other hand, you might have a bunch of losses you could use in this tax year to offset the gain.

Additionally, IRC Section 453 allows deferral of tax for only \$5 million in installment sales per year. If the original principal balance of the seller carry-back installment note surpasses \$5 million, then you will owe interest on the tax being deferred.<sup>4</sup>

**Remember to study the fine print.** There are tests that your failed 1031 exchange has to pass. The first test is marked by the calendar: the sale proceeds involved in the exchange have to have spent at least 45 days in a qualified trust or escrow account. You also have to show intent. You need to be able to demonstrate that you made real effort to acquire a like-kind property, with reason to think you would find one within the identification period.<sup>1</sup>

**Above all, see your tax advisor.** If you have a like-kind exchange in mind as the year winds down or seemingly can't pull one off as another year begins, then it is a good idea to keep this potential for tax deferral in mind. You will definitely want to consult a qualified tax advisor, and you should head to the IRS website ([www.irs.gov](http://www.irs.gov)) and download a copy of Publication 537. (That's the one covering installment sales.)

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#### **Citations**

- 1 [irs.gov/newsroom/article/0,,id=179801,00.html](http://irs.gov/newsroom/article/0,,id=179801,00.html) [3/5/08]
- 2 - [realtymtimes.com/rtpages/20050719\\_usingexchanges.htm](http://realtymtimes.com/rtpages/20050719_usingexchanges.htm) [7/19/05]
- 3 - [allstates1031.com/news-events/newsletters/reporting-gain.php](http://allstates1031.com/news-events/newsletters/reporting-gain.php) [6/3/10]
- 4 - [exeter1031.com/seller\\_carry\\_back\\_financing.aspx](http://exeter1031.com/seller_carry_back_financing.aspx) [6/3/10]