



Tax Straddling

Which Year To Pay Taxes?

A Benefit for Unsuccessful 1031 Exchanges

Taxpayers should not be hesitant to structure their sales as 1031 tax deferred exchanges if they are concerned that they may be unable to locate new properties to complete their exchange. A benefit may exist for a calendar-year taxpayer who initiates a 1031 tax-deferred exchange during the last few months of this year only to find that the exchange fails (they are unable to purchase new replacement property within the time periods set forth in Section 1031). Since the exchange period will go into 2019, the IRS provides an option called “tax straddling” which allows most taxpayers to pay the tax that is due on their 2019 return as opposed to their 2018 return.

Of course the major benefit for a taxpayer who successfully completes a 1031 Exchange is 100% deferral of taxes and the ability to invest all of their equity into new property. Unfortunately, if a taxpayer is not able to purchase new property to successfully complete the 1031 Exchange, the taxes associated with the sale of their investment property will be due. However due to “tax straddling” the taxpayer may receive a one year tax payment deferral thanks to the coordination between IRC §453 and §1031 provided in the §1031 regulations.

How does this work? If a delayed 1031 exchange begins in the latter portion of 2018, the exchange period may run into 2019. If the exchange fails or if the taxpayer (having a bona fide intent to do an exchange) receives cash boot in 2019, the 1031 regulations treat the exchange as an installment sale allowing the taxpayer to consider that the exchange proceeds were received (and are taxable) in 2019.

However, if a taxpayer prefers to pay their taxes as soon as possible, in accordance with IRC section 453 (d) a taxpayer may “elect out” of the installment method. By electing out, the taxpayer can recognize the gain in 2018 instead of 2019. To elect out, the sale should be reported on Form 8949, Form 4797 (or both) and not on Form 6252. The election must be made by the due date, including extensions, for filing the 2018 tax return. For more information about the procedure and forms to use, see IRS Publication 537 and consult with your tax advisor. Additionally, tax straddling does not apply to all sales and any gain attributed to debt relief will have to be recognized in the year of sale.

The IRS does not penalize investors for attempting to complete a 1031 Exchange. Tax straddling provides an added incentive to taxpayers selling investment property at the end of the year. Why not attempt to complete a 1031 Exchange when a one year payment deferral is available as the back-up plan?

Please call us at IPX1031 to discuss tax straddling and other valuable tax-deferral solutions. Be sure to consult with your tax advisor before participating in a 1031 exchange.

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