What Happens if a 1031 Exchange Spans Two Tax Years?

It is important for exchangers to consider the tax implications of completing a 1031 exchange that spans two tax years. If you are starting an exchange late in the year, it is imperative to pay close attention to exchange deadlines.

Most taxpayers who are considering a Section 1031 exchange are familiar with the 45-day Identification period, and the 180-day Exchange period. As a reminder, the taxpayer must identify the Replacement Property (or Properties) to be acquired within 45 days after the sale of the Relinquished Property. Section 1031(a)(3)(b) says that taxpayers must complete their 1031 exchanges within 180 days after the sale of their relinquished property, or the due date of their tax return, whichever is earlier. For most taxpayers, and in most years, the tax return due date is April 15 of the following year.

But for taxpayers who sell investment real estate in the fourth quarter as part of a 1031 exchange, it is imperative to pay particularly close attention to the exchange deadlines.

Realize Full Exchange Timeline by Filing for an Extension on Taxes

For example, if you sell your relinquished property after October 17, 2020, you must complete your 1031 tax exchange by April 15, 2021, or you must file for an extension on your 2020 taxes. This means that if you sell your investment property on November 30, 2020, for example, you will have an exchange deadline of April 15, 2021 – which is only 136 days later. To have the benefit of the full 180-day exchange period, you would have to file for an extension.

Filing for an extension on your tax return requires submission of Form 4868 and will provide you with a six-month extension on your income taxes. This does not, however, provide you with an additional six months to complete your 1031 exchange, but rather, the balance of your 180 days, which in November 30 example above, moves the deadline to May 29, 2021. Note that for the exchanger in this example, deadline now falls on a Saturday, which does NOT get extended to Monday, May 31.

Convert Failed 1031 Exchange to Installment Sale

Alternatively, you could opt to let your exchange fail. Our November 30 example above has a 45-day identification deadline of January 14, 2021, and a 180-day exchange deadline of May 29, 2021. Whether the 1031 exchange fails by non-identification or by failure to acquire replacement property, you are not entitled to obtain the exchange proceeds until the subsequent tax year. In this example, the IRS allows you to either report the gain in the year of the sale, or in the year the proceeds were received under Section 453 installment sale rules. Choosing the installment sale rules would require you to file Form 6252, but effectively provides a one-year deferral on the gains from the sale of the property. Deciding to convert from a failed 1031 exchange to an installment sale does not result in any IRS penalties, and provides you with additional flexibility. Indeed, the default reporting of an unsuccessful exchange that crosses tax years is the installment sale method unless you affirmatively choose to report it in the prior year.

Keep in mind that the rules for Section 453 installment sales are quite specific. Installment sales do not necessarily apply to all sales, and do not defer any gain that was attributable to debt relief. Taxpayers are strongly encouraged to discuss the concepts covered here with their tax and/or legal advisors.