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To Extend or Not to Extend—Is That the Only Question?

Special Considerations for Late Year Like-Kind Exchanges

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by Holly Belanger, Debbie Fields, and Cathy Fitzpatrick, Washington National Tax*

Sometimes a like-kind exchange straddles two different tax years, raising questions about extending return filing deadlines, installment sale reporting, and allocating partnership liabilities under section 752.

A taxpayer who sells real property held for productive use in a trade or business or for investment and not held primarily for sale (the relinquished property) may defer the recognition of its gain realized for U.S. federal income tax purposes by structuring the sale as a deferred like-kind exchange under section 1031(a)(3).¹ Under the deferred exchange rules, the taxpayer may have up to 180 days from the date of sale to reinvest the sale proceeds in qualified like-kind replacement property (i.e., real property that is also held for productive use in a trade or business or for investment and is not held primarily for sale). If the sale of the relinquished property occurs near the end of the taxpayer's tax year, the deferred exchange will straddle two tax years. This article outlines certain considerations that a taxpayer should take into account when entering into a deferred exchange at the end of its tax year.

* *Holly Belanger is a partner in and Debbie Fields is the partner-in-charge of the Passthroughs group of Washington National Tax ("WNT"). Cathy Fitzpatrick is a partner with the WNT Income Tax & Accounting group.*

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Extending the Tax Return to Receive the Maximum Exchange Period

To defer the gain realized on the disposition of relinquished property in a deferred like-kind exchange, the taxpayer must acquire all of its replacement property during the “exchange period.” The exchange period begins on the date the taxpayer sells the first relinquished property in the exchange.² The exchange period ends on *the earlier of*: (1) the day that is 180 days after the date on which the taxpayer transferred the first relinquished property; or (2) the due date (determined with regard to extension) for the taxpayer’s tax return for the tax year in which the relinquished property was sold.³ As a result, a calendar year taxpayer who sells its relinquished property late in its tax year may need to extend its tax return for the year of sale to obtain the benefit of the entire 180-day exchange period.

Example 1

B, an individual, sells relinquished property in a like-kind exchange on December 15, 2020. B’s exchange period under section 1031(a)(3)(B) ends on the earlier of (1) June 13, 2021 (the date that is 180 days after the date of sale); or (2) the due date of B’s return, including extensions. If B does not extend her 2020 tax return, B’s exchange period will end on April 15, 2021 (the unextended due date of B’s return). If B has not acquired sufficient replacement property by April 15, 2021, B must either extend her return (so that the exchange period is extended to June 13, 2021) or her exchange will end on April 15, 2021, resulting in the potential recognition of gain.⁴

For 2020, calendar year partnerships and S corporations that sell relinquished property on or after September 17, 2020, may need to consider extending their 2020 tax returns if the taxpayer wants the maximum 180-day exchange period. Similarly, individuals, C corporations, and other taxpayers with an original tax return due date of April 15, 2021, who sell relinquished property on or after October 18, 2020, may need to consider extending their 2020 tax returns.

Not Extending to Receive Early Release of Cash Boot

There are situations in which extending a taxpayer’s return to achieve the maximum 180-day exchange period may not be desirable. If, on or before the original due date of its tax return, a taxpayer knows that it will not reinvest any sale proceeds remaining from the relinquished property, extending its tax return may inadvertently delay the taxpayer’s receipt of the remaining sale proceeds from its qualified intermediary.

The deferred exchange regulations under section 1031(a)(3) require the taxpayer to place restrictions on the taxpayer’s ability to access sale proceeds during the exchange period. In particular, section 1.1031(k)-1(g)(6) requires that the taxpayer’s exchange agreement with its qualified intermediary (or trust or escrow agreements with a qualified trustee or qualified escrow holder) specifically provide that

² Section 1.1031(k)-1(b)(2).

³ Section 1031(a)(3)(B).

⁴ See *Christensen v. Commissioner*, T.C. Memo 1996-254, *aff’d*, 142 F.3d 442 (9th Cir. 1998) (concluding that property acquired after the original due date of the taxpayer’s return when no extension was filed was not qualified replacement property under section 1031(a)(3)(B)).

the taxpayer has no rights to receive, pledge, borrow or otherwise obtain the benefit of money or other property *before the end of the exchange period* (emphasis added). If the taxpayer extends its tax return, an exchange period that would otherwise have ended on the due date of the return will not end until 180 days after the date of sale. As a result, the qualified intermediary will retain any remaining sale proceeds until 180 days after the date of sale.

Example 2

On December 15, 2020, B, an individual, sells relinquished property for \$1 million in a sale structured as part of a deferred like-kind exchange using a qualified intermediary. B timely and properly identifies three properties as potential replacement properties. On March 15, 2021, B acquires one of the identified properties for \$750,000. On or before April 15, 2021, it is clear to B that she will not be able to acquire either of the two remaining identified replacement properties and, thus, will have \$250,000 in boot on the exchange transaction. Under the terms of B's exchange agreement with her qualified intermediary, the qualified intermediary is required to hold the remaining \$250,000 sale proceeds until the end of the exchange period. If B does not extend her 2020 tax return, the exchange period will end on April 15, 2021 and the qualified intermediary will release the \$250,000 cash boot to B shortly thereafter. However, if B extends her 2020 tax return, B's exchange period will not end until June 13, 2021. Pursuant to the terms of the exchange agreement, the qualified intermediary will not release the remaining \$250,000 sale proceeds to B prior to June 14, 2021.

If a taxpayer knows that it will not reinvest 100 percent of its sale proceeds in qualified replacement property, the taxpayer should consider its restricted access to any remaining sale proceeds during the exchange period when determining whether to extend its tax return for the year of sale.

Electing out of Installment Sale Reporting

When a taxpayer disposes of property, section 453 may require the taxpayer to report any gain recognized using the installment method if at least one payment is to be received by the taxpayer after the close of the tax year of disposition.⁵ When a taxpayer disposes of relinquished property in a deferred exchange that straddles two tax years, any sale proceeds that are not reinvested in replacement property generally will be received by the taxpayer at the end of the exchange period, which will occur in the tax year after the year of disposition. As a result, a taxpayer who recognizes gain on a deferred like-kind exchange that straddles two tax years may be required to report the gain under the installment method.⁶

For many taxpayers, the use of the installment method allows the taxpayer to defer its gain recognized for one year even though the like-kind exchange fails, in whole or in part. However, there are situations

⁵ Section 453(a), (b)(1).

⁶ Section 1.1031(k)-1(j)(2). Use of the installment method of reporting in connection with the receipt of boot in a deferred like-kind exchange requires that the taxpayer have a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. The section 1031 deferred exchange rules cannot be used to create the appearance of an installment sale by parking funds with a qualified intermediary when it is evident from the facts that no bona fide exchange was ever contemplated. Section 1.1031(k)-1(j)(2)(iv).

in which the taxpayer may consider electing out of the installment method of reporting so that the taxpayer's gain is recognized in the year of sale, rather than in the subsequent year when the payment is made by the qualified intermediary.⁷ For example, interest is charged on the tax deferred under the installment method if the relinquished property has a sale price over \$150,000 and the aggregate balance of all installment obligations of the taxpayer outstanding at the close of the tax year exceeds \$5 million.⁸ A taxpayer may determine that the interest charge on the deferred gain outweighs the benefit of one year of deferral and, therefore, may decide to elect out of the installment method of reporting.

Accordingly, if an exchange that straddles two tax years results in the recognition of gain, in whole or in part, the taxpayer should consider the extent to which the installment method of reporting under section 453 applies to the gain recognition and whether it is more cost effective to elect out of the installment method.

Partnership Liability Allocations

In general, a partner includes its share of partnership liabilities in the basis of its partnership interest. Specifically, an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership under section 752(a). Similarly, a decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner under section 752(b). If, as a result of a single transaction, a partner incurs both an increase and a decrease in the partner's share of partnership liabilities, only the net increase is treated as a contribution by the partner and only the net decrease is treated as a distribution to the partner.⁹

A deemed distribution of money under section 752(b) is generally taken into account by the partner at the end of the partnership's tax year.¹⁰ If the distribution exceeds the partner's basis in its partnership interest at that time, the partner recognizes gain under section 731.

If a partnership sells encumbered relinquished property in a deferred like-kind exchange that straddles the partnership's year-end and the partnership has not acquired encumbered replacement property by the end of the tax year, is there a deemed distribution under section 752(b) to the partners from the decrease in partnership liabilities? Can the partners net any increase in liabilities from the replacement property acquired in the following year with the decrease in liabilities resulting from the sale of the relinquished property in the current year because each step of a deferred exchange is part of a "single transaction" within the meaning of section 1.752-1(f) even though the steps occur in different tax years?

Fortunately, in Revenue Ruling 2003-56,¹¹ the IRS concluded that, in a deferred like-kind exchange, a partner may net a decrease in liabilities on the sale of the relinquished property with an increase in

⁷ Section 453(d).

⁸ Section 453A(b).

⁹ Section 1.752-1(f).

¹⁰ Rev. Rul. 94-4, 1994-1 C.B. 196 (concluding that a deemed distribution of money under section 752(b) is treated as an advance or draw of money under section 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership's tax year).

¹¹ 2003-1 C.B. 985.

liabilities from the acquisition of the replacement property even if the exchange straddles two partnership tax years. Thus, if a partnership enters into a deferred like-kind exchange in which encumbered relinquished property is sold in one tax year and the encumbered replacement property is acquired in the following tax year, the liabilities on the properties are netted under section 752 to determine whether each partner has a net increase or net decrease in partnership liabilities at the end of the first year. Any net decrease in a partner's share of partnership liabilities is taken into account under section 752(b) in the first tax year (i.e., the year of sale). Any net increase in a partner's share of partnership liabilities, however, is taken into account in the second tax year (i.e., the year of acquisition).

Example 3

On December 1, 2020, PRS, a partnership for U.S. federal income tax purposes, sells encumbered relinquished property in a sale structured as a deferred like-kind exchange. The relinquished property has a FMV of \$100,000, adjusted tax basis of \$40,000, and is subject to a mortgage of \$50,000 which is satisfied with proceeds from the sale.

PRS has two equal partners, X and Y, at the time of sale. X and Y each have an adjusted tax basis of \$20,000 in its PRS interest. All debt of PRS is allocated equally between X and Y.

On February 1, 2021, PRS acquires replacement property with a FMV of \$100,000. PRS uses the \$50,000 of net sale proceeds from the relinquished property and incurs a new mortgage of \$50,000 to acquire the replacement property.

Under Revenue Ruling 2003-56, on December 31, 2020, neither X nor Y has a deemed distribution of money under section 752(b) because each can net its \$25,000 increase in liabilities from the replacement property acquired in February 2021 with the partner's \$25,000 decrease in liabilities from the sale of the relinquished property in December 2020.

It should be noted that Revenue Ruling 2003-56 authorizes a partner to take into account only its share of liabilities incurred to acquire the replacement property in determining whether the partner has a net decrease in partnership liabilities under section 752(b) at the end of the prior tax year. If the partnership does not finance the acquisition of the replacement property with debt, the partners are not allowed to take into account equity contributions made in, or earnings of the partnership from, the subsequent tax year in determining whether the partner has a deemed distribution under section 752(b) that exceeds the basis of her partnership interest in the prior year.

Any partner with a negative tax basis capital account in the partnership will be sensitive to changes in the amount of partnership liabilities allocated to the partner under section 752 as a decrease in the partner's debt allocation could trigger gain under section 731. If a partnership with partners who are sensitive to their debt allocation under section 752 enters into a deferred like-kind exchange of encumbered property and the exchange straddles the end of the partnership's tax year, then the partnership should consider how it intends to finance the acquisition of the replacement property. If it is possible that the partnership will not incur additional debt to make the acquisition (i.e., the partnership will not replace the debt on the relinquished property with debt on the replacement property), then the

impact of the partnership debt reduction on the partners in the year of sale, especially those with negative tax basis capital accounts, should be analyzed. It is possible that additional planning may need to be considered either to prevent the deemed distribution of money to those partners¹² or to increase those partners' bases in their partnership interests prior to the end of the tax year of sale.¹³ Any planning done to reduce the extent to which a partner has a deemed distribution in excess of its basis must be completed before the end of the partnership's tax year of sale.

For more information regarding like-kind exchanges under section 1031 or to evaluate the consequences of a late year exchange, please contact [Holly Belanger](#) or [Debbie Fields](#). For more information on the application of the installment sale rules under section 453, please contact [Cathy Fitzpatrick](#).

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¹² For example, because of the adverse effect on the partners from a decrease in partnership liabilities, the partnership may decide that it is more cost effective for the partnership to incur a liability to acquire the replacement property.

¹³ For example, the adversely affected partners could consider guaranteeing other partnership debt prior to the end of the tax year. To the extent a partner is considering guaranteeing partnership debt or indemnifying other partners with respect to partnership debt, the contractual relationship must be respected under section 1.752-2(b)(3). See final regulations under section 1.752-2 issued on October 4, 2019 (T.D. 9876 and T.D. 9877).