What Not To Do In a Delayed Exchange

1031 Knowledge

Delayed exchanges, under IRC Section 1031, are the most common exchange format and strict statutory rules and requirements exist to obtain 1031 tax deferral. In a delayed exchange, a taxpayer must meet a number of time deadlines after closing on the sale of a relinquished property:

1. Acquire the replacement property within a maximum of 180 calendar days after closing on the sale of relinquished property, or the day the taxpayer's tax return is due, whichever is earlier (the "Exchange Period")

   - and -

2. Either acquire all replacement property or properties or properly identify all potential replacement properties within 45 calendar days from the relinquished property closing (the "Identification Period").

Below are three tax court decisions highlighting what not to do in a delayed exchange:

<u>Orville Christensen v. Commissioner, 98-1. USTC ¶50,352 (Ninth Circuit Court of Appeals)</u>

What Happened: The Christensen's filed their tax return on April 15 and acquired replacement property within 180 calendar days, but the purchase of replacement property closed after they had already filed their tax return. The tax court cited failure to comply with the deadlines, specifically the requirement to complete the 1031 exchange within 180 days or the tax filing date, whichever is earlier, as the reason tax deferral was not allowed.

What Should Have Happened: The Christensen's should have filed a tax extension prior to closing on the purchase of the replacement property to have the entire 180-day exchange period available to purchase like-kind property.

<u>David A. and Marilyn P. Knight, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1998-107 (March 16, 1998)</u>

What Happened: On day 179, the Knight's purchase of their replacement property fell apart. The Knight's

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acquired another property that was properly identified within the 45-day identification period but after the expiration of the 180-day exchange period. The Knight's argued they made a "good faith" attempt to meet the 1031 exchange time requirements. The tax court denied the 1031 exchange because the tax code has statutory language and clearly allows only a maximum of 180 calendar days to complete an exchange.

What Should Have Happened: The Knights should not have postponed their replacement property acquisition to last moment if at all possible. Had more time been available, they may have been able to acquire another properly identified replacement property before the end of the 180-day exchange period.

<u>David Dobrich and Naomi Dobrich, Petitioners v. Commissioner of the Internal Revenue, Respondent; USTC Tax Court Memorandum 1997-477 (October 20, 1997)</u>

What Happened: The Dobrich's intentionally "backdated" an Identification Notice. This was discovered by the IRS and they were liable for the full capital gain taxes owed ($2.2 million) plus they had an additional 75% fraud penalty ($1.6 million.) As a result of the attempted tax fraud, the owed over $3.8 million which far exceeded the taxes they would have owed in a taxable sale.

What Should Have Happened: The Dobrich's should have acquired only property properly identified within the 45-day identification period. Tax fraud is a crime and under no circumstances should taxpayer ever consider trying to backdate an identification notice.

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