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Mind Reading 101: How IRS views qualified property

November 03, 2011 - Front Section

Most real estate owners will tell you that if they bought a property for $100,000 and sold it a few months later for $150,000, it was a great investment. If they also deferred paying taxes by doing a 1031 Exchange, they may consider themselves genius! However, the IRS would not consider this an act of genius; and likely determine their exchange invalid because they sold inventory, not investment property, therefore taxes, interest & penalties would be assessed.

In order to obtain the tax deferral, the property must be held for productive use in a trade or business or for investment (qualified use). The intent by the taxpayer to instead hold property "primarily for sale" will prevent the property from qualifying. While most properties owned by builders, developers and those planning to fix up and resell will be considered held primarily for sale, the IRS looks to the intent at the time of sale.

Factors to determine if the taxpayer's property was "held for sale":

1. Frequency and number of real estate transactions entered into. The more property sales by the Exchanger, the more likely the IRS will consider the property "held for sale", not qualifying for 1031 treatment (i.e. one who buys foreclosed/distressed properties, fixes them up and then immediately attempts to flip for a quick profit).

2. Nature and extent of efforts to sell the property - the taxpayers sales efforts, including advertising, use of sales personnel, etc. The IRS will look at the proportion of the Exchanger's income that is derived from the sale of the property, and the extent of the taxpayer's involvement, time, effort and control over the sales activities. The time factor alone generally is not what determines intent.

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