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Differing interpretations of property "held for investment" or "for use in a trade or business"

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The benefits of Internal Revenue Code Section 1031 are well known to real estate investors. Current recognition of gain on the sale of property "held for investment" or "for use in a trade or business" can be deferred provided the property is exchanged for property that is like-kind.

Both the property relinquished and the property received in the exchange must be held "for investment" or "for use in a trade or business" (IRC Â§1031(a)(1)). The property cannot be personal use property or a principal residence.

The inquiry will turn on whether a taxpayer can demonstrate that his intent was to hold the property for investment -- and whether the taxpayer's actions evidenced that intent.

A number of recent tax court decisions have highlighted the issue of property held for investment.

In Yates v. Commissioner (T.C. Memo 2013-28), taxpayers moved into their recently acquired replacement property 4 days after closing. Taxpayers pointed to their request that the seller of the property apply to the town for approval that the property be used as a bed and breakfast as evidence of their investment intent. No such application was made. The court concluded that occupying the property as a principal residence precluded the taxpayer from claiming the property was held for investment.

In Adams v. Commissioner (T.C. Memo 2013-7) taxpayer exchanged rental property for a single family home in Eureka, Calif. which he proceeded to rent to his son. The son made the home habitable including dealing with squatters, mold, and vermin (including chasing a bear away from the property).

The rent paid by the son was a few hundred dollars below market rent. The IRS initially disallowed the exchange on the grounds that the taxpayer acquired the property for personal use purposes - specifically to allow his son to live in the home at below-market rent. The court concluded the property was in fact held for investment and that the rent paid by the taxpayer's son was appropriate given the level of rehabilitation and upkeep the son provided without charge.

In Patrick A. Reesink v. Commissioner (T.C. Memo 2012-8) taxpayer and his brother owned an apartment complex in San Francisco. After many years of turmoil, including taxpayer accusing his brother of stealing from him, trying to strangle him and attempting to poison him by putting cleaning fluid in his drinking water, taxpayer filed for partition of the property.

The partition suit was settled and the property was sold. Taxpayer exchanged his interest in the property for a single family home in Guernville, Calif. After trying for eight months to rent the property, without success, taxpayer sold his primary residence and moved into the Guernville property.

The IRS disallowed the exchange on the grounds that the property was not held for investment as evidenced by the fact that taxpayer occupied the home as his residence a few months after

acquiring the property. The tax court disagreed and found that the taxpayer's actions, which included advertising the home for rent and interviewing a number of prospective tenants, evidenced his intention to hold the property for investment.

Taxpayer did not have such luck in Goolsby v. Commissioner (T.C. Memo 2010-64). Husband and wife sold property held for investment and acquired two replacement properties. The court considered whether one of the replacement properties, a single family residence, was acquired to be held for investment.

Taxpayers attempted to rent the home for two months after acquiring it, upon failure to do so, they moved into the property as their primary residence. Taxpayer's acquisition of the property was contingent on taxpayer's sale of their primary residence and correspondence with their qualified intermediary revealed their lack of investment intent. The court concluded the property was not held for investment.

Taxpayer sold a vacation home and acquired a new vacation home in Barry E. Moore v. Commissioner (T.C. Memo 2004-134). The transaction that preceded the issuance of Rev. Proc. 2008-16 (which provides a safe harbor under which a dwelling unit qualifies as property held for investment or for use in a trade or business under IRC Section 1031).

The IRS disallowed the exchange on the grounds that the properties were held for personal use and not for investment. Taxpayer argued that his investment intent was evidenced by his hope that the properties would appreciate in value resulting in a profit when sold.

The facts show the taxpayer used the properties for recreational activities for two weekends per month between March and September, claimed a home mortgage interest deduction on the properties, and did not depreciate the properties. The court concluded that the mere hope that the properties would appreciate does not establish investment intent if the taxpayer uses the properties as a residence and that a preponderance of the use must be qualified use.

Many of the requirements for a successful tax-deferred exchange are unambiguous. Others are open to interpretation. Taxpayers are best served by obtaining professional legal or tax advice in order to ensure compliance with the tax law and maximize their deferral.

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