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Question of the Month: Is now a good time to do a Section 1031 exchange? Consider all the facts before you decide

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With real estate markets generally continuing to improve across the U.S., many investors are thinking about selling their real property. If they want to also buy real property, then they should be thinking about doing a Section 1031 exchange. A Section 1031 exchange provides a substantial tax benefit by deferring the taxes that would otherwise be due on the sale of real property, which enables a seller to put the cash that would have been used to pay the taxes on the sale towards the purchase of the property he/she wants to buy. With more properties now for sale, a seller has a better selection of properties to buy to complete his/her exchange. So, yes, now is a good time to do a Section 1031 exchange - particularly since one of the most frequent stumbling blocks to completing Section 1031 exchanges in recent years has been the lack of suitable replacement property on the market.

There has been some negative commentary about the risks of doing a Section 1031 exchange that I would like to address. This negative press has arisen mostly due to a recent U.S. District Court case, *Allen v. U.S.* (N.D. Cal. 2014), where the court determined that Mr. Allen, who owned a parcel of undeveloped real estate for 12 years, was not an investor, but had held the property for sale to customers in the ordinary course of his trade or business. This, of course, meant that the property was not a capital asset for income tax purposes, and the gain on his sale of that property was taxable at ordinary income rates, rather than the more favorable capital gains rates.

This case is relevant to Section 1031 exchanges because a very similar standard applies to the qualification of property sold or purchased as part of an exchange. Only properties that are held for productive use in a trade or business or for investment qualify for the tax benefits of a Section 1031 exchange. A property that is held for sale to customers in the ordinary course of business does not meet either prong of this test.

The result in the *Allen* case seems bizarre since one of the hallmarks of investment property is holding it for a long period of time in order to reap the benefits of long-term appreciation in value through market forces, rather than "flipping" it for short-term gains. So what happened in this case? What went wrong for the taxpayer?

In the *Allen* case, the facts were just bad. The taxpayer had spent a lot of time and energy over the 12-year period attempting to develop the property for a multi-unit project himself. Ultimately, his attempts were unsuccessful, and he sold the property to a developer who did develop it and paid him over a period of several years according to a formula which gave him 22% of the profits and a set fee whenever a unit was sold. The taxpayer argued that his intent with respect to the property had changed over time so that it became "investment property," but he did not provide any evidence of when his intent had changed. For payments received in years prior to 2004, he had reported the gains as "other income" on his tax returns, i.e., not long-term capital gain; and for his 2004 return he

characterized the final payment as both long-term capital gain from the sale of a partnership interest and as "other income." So it is not very surprising that the court found that the taxpayer did not carry his burden of proof necessary to defeat the government's motion for partial summary judgment on his refund claim. The taxpayer produced so little evidence that he did not create a material issue of fact (a fairly low threshold) as to his intent, which would have enabled his claim to survive the motion for summary judgment.

Intent is just as important for the qualification of properties to be sold and purchased in a Section 1031 exchange. For many years, the IRS' position is that the exchanger's intent in holding the property is determined at the time of the exchange without regard to the taxpayer's motive before the exchange, and it has recognized in rulings that a taxpayer's intent with regard to a property can change. This is inherently a factual determination, and so there are a number of perhaps surprising court decisions which recognize short holding periods for exchanged properties of three to six months - or even five days in one case!

Essentially, what this means is that while holding real property for a long period of time helps demonstrate an investment intent for Section 1031 exchange purposes, as the Allen case shows, it is not the only factor that is considered. As long as you have solid evidence of intent to hold as investment property, a short holding period should not preclude you from accepting a really good offer. But before you sell, consider all the facts, and think about what you can do now to bolster the case that you were holding the property for investment.

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