nerej
Celebrating 55 years

Do quick sales qualify for tax deferral? The key is what was the intent when the property was purchased

May 28, 2015 - Spotlights

If a real estate investor bought a property for $475,000 and sold it a month later for $700,000, they would most likely tell you that it was a great investment. That same investor would probably tell you that good fortune struck twice if they also deferred paying the capital gain tax on their profits when they sold the property by utilizing a Â§1031 Exchange.

Unfortunately the investor may later discover that this quick sale did not qualify for tax deferral under Section 1031. However, there are instances when holding an investment property for a short time will qualify. How do taxpayers know if a quick sale will qualify for the tax deferral treatment? The key factor is what the taxpayer's intention was when the property was purchased.

If the taxpayer's intention at the time of purchase was to hold the property for investment purposes or for productive use in the taxpayer's trade or business and was not intended "primarily for sale," 1031 Exchange treatment may qualify. For example, if an investor buys a building with the intention of holding it for investment and receives an incredible unsolicited offer a few months later, that transaction will probably qualify for 1031 tax deferral treatment. Be aware that although most properties owned by developers, builders and rehabbers generally are considered to be held "primarily for sale," the IRS looks to the intent of the investor/taxpayer in every situation.

Intent is a fact and circumstance test involving a number of factors. Factors that the IRS looks at to determine the presence (or absence) of a qualified intent include:

The frequency and number of real estate transactions entered into by the taxpayer. The more property sales a taxpayer has, the more likely the IRS will find that the taxpayer is a "dealer," that the property is "held primarily for sale," and does not qualify for exchange treatment. An example is the investor who buys foreclosed/distressed properties, fixes them up and then immediately attempts to "flip" for a quick profit.

The development activity of the taxpayer. This includes the taxpayer's activities, such as subdividing the property, adding streets, roads, sewers, utility services, rezoning and renovating the property. The IRS looks at the extent that the gain on the sale of the property was attributable to the taxpayer's own efforts relative to the property as opposed to a gain due to external factors. Subdividing a property will not necessarily prevent a taxpayer from receiving exchange treatment on the disposition of the property, but the development activity may.

The nature and extent of efforts by the taxpayer to sell the property. Sales efforts of the taxpayer, such as advertising, use of sales personnel, a sales office to sell individual lots in a subdivision, or listing with and delegating sales activities to a broker, will be reviewed to determine 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 regarding the property.

The time factor alone, or how long the property was held by the taxpayer prior to sale, is not what determines intent. Intent involves a number of factors that will be taken into consideration. Although we strive to help our clients and their advisors keep current on tax issues pertaining to Â§1031 Exchanges and applications for them, taxpayers are always advised to consult with their tax and legal advisors regarding the exchange status of a property prior to selling their property. IPX1031 - your complete information resource.

Patricia Flowers is vice president for Investment Property Exchange Services, Inc. (IPX1031), Boston, MA.