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How long should I hold a prop. in order to qualify as investment prop. with 1031 tax-deferred exchange? - by Greene and McCue

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The continuing strong real estate market in the Greater Boston area and throughout New England has given investors substantial equity in their properties subjecting them to higher capital gains taxes on the sale of such properties. Consequently, more investors, both U.S. and foreign, are using

1031 tax-deferred exchanges in order to defer paying capital gains taxes.

Internal Revenue Code (IRC) Section 1031 provides “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.” Investors enter into exchanges for a number of different reasons. They may want to diversify, consolidate or purchase other investment property that has a better income stream or more upside than the property they currently own.

We are frequently asked how long a taxpayer must hold title to a property in order for the property to qualify under IRC Section 1031. The answer is that there is no bright-line rule for a holding period, and it is a facts and circumstances test. If a taxpayer is audited, the taxpayer will have to prove to the IRS that his “intent” when he purchased the property was to hold the property for investment purposes.

As such, if a taxpayer purchased a property with the intent to sell that property, regardless of whether he develops or improves it or how long he holds title to the property, then this property would NOT meet the rules of IRC Section 1031, and therefore, would not be eligible.

A few years back, I had a client who bought a building in Brookline, Mass. that was zoned as a lodging house. The client’s intent upon purchasing the property was to rent it out, perhaps to a college fraternity or possibly to master lease it to a local university. The client enlisted a local real estate company who advertised the building for rent. After only three months of owning it, a prospective buyer came along and offered my client almost twice the amount that he paid for it. The client asked me if he could do a 1031 tax-deferred exchange. My answer to him was that if he is audited by the IRS, he would have to prove to them that his intent was to hold the property for investment purpose. One of the factors that the IRS would look at in order to determine intent of a taxpayer is how long the taxpayer owned the property.

Even though there is no bright-line rule that states how long a taxpayer must hold title to a property in order for the property to be considered investment property, most 1031 tax practitioners feel that if a taxpayer holds on to a property for greater than two years, and is actively renting it, then that is a fairly “safe” holding period. One of the reasons they feel this way is that IRC Section 1031 has other rules that require a two year holding period. For instance, if you sell or buy from a related party, the taxpayer and the related party must hold the property for two years. In my client’s case, even though he only held the property for three months, he could still prove his intent as an investor by demonstrating that the property was listed for rent, and that he was then offered almost twice as much as he had paid for the property just three months prior. All the facts and circumstances will be looked at in addition to length of time that the property was held by the taxpayer.

The major difference for tax purposes between an “investor” and a “developer” is that an investor pays capital gains taxes and developers pay ordinary income taxes. Ordinary income taxes are generally higher than capital gains taxes so it’s typically beneficial to be taxed as an investor.

This article is a very brief overview of the tax implications of being a developer versus an investor in connection with a 1031 tax deferred exchange. Taxpayers should always engage experienced legal, financial and tax advisors before entering into an exchange.

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