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Qualifying real property in a 1031 Exchange: Understanding the importance of investment intent - by Lynne Bagby

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Surprisingly, some savvy real estate investors in New England may not be aware of the requirement that both the relinquished property being sold and the replacement property being purchased in a 1031 exchange must be “held for investment or productive use in a trade or business.” After the passage of Tax Cuts and Jobs Act (TCJA), only real property can be exchanged as personal property no longer qualifies for Section 1031 tax deferral. So, what is the meaning of the phrase “held for investment or productive use in a trade or business?”

First, determining whether property is qualifying real property held for investment is a facts and circumstances test. Listed below are some of the factors that the IRS may consider to evaluate if a property was held for investment purpose versus held for sale:

- The purpose for which the property was initially acquired;
- The purpose for which the property was subsequently held;
- The purpose for which the property was being held at the time of sale;
- The extent of advertising, promotion or other active efforts used in soliciting buyers for the sale of the property;
- The listing of property with brokers;
- The extent to which improvements, if any, were made to the property;
- The frequency, number and continuity of sales;
- The extent and nature of the transaction;
- The ordinary course of business of the taxpayer;

How long the property has been owned

The opposite of holding property for investment is holding property primarily for sale. Dealers, those who buy and “flip” properties, and those that buy to fix up and quickly sell generally hold primarily for sale purposes. Activities that an investor may not suspect could indicate an intent to hold primarily for sale which could disqualify an intended 1031 exchange include listing the property for sale, negotiating contracts for sale, making substantial improvements to the property, rehabbing activities, and continuously buying and reselling property without rental investment activity during ownership.

On the other hand, holding property for investment can include activities such as leasing property, showing the property to prospective tenants, marketing the property for rent, collecting rents, maintaining property and reporting income/investment expenses on tax returns.

Second, the holding period is not determinative in and of itself and there is no holding period set forth in IRC Section 1031 that will guarantee that an investor has held for investment purposes. As demonstrated in *Allen v. U.S.* 113 aff’d2. d 2014-2262 (2014), the intent of the taxpayer is more important than the length of the holding period. In *Allen*, the taxpayer owned the property for over 10 years but admitted that he originally acquired the property to develop and resell it. He argued that, over the course of time, he changed his mind and decided not to develop the property, but continued to hold it “for investment” until he could sell it. However, the tax court found no evidence of the taxpayer’s intent changing from holding for development to holding for long-term investment purposes. In the absence of objective facts to support *Allen*’s assertion that his intent changed, the Tax Court determined that his intent never did change. This outcome highlights the importance of the taxpayer having enough documentation and tangible facts to support their intent to hold for investment purposes to qualify for 1031 exchange tax deferral.

Although the intent with respect to an investment property can change over time, the intent during the period prior to the sale is critical. See, *Tibbals v. United States*, 362 F.2d 266, 273 (1966). The court determined in *Allen* that the taxpayer failed to show when, how, or why his intent changed from holding for development to long-term investment.

In addition, regardless of establishing that a property may be qualifying property, certain types of property will never qualify for Section 1031 tax deferral because they do not constitute real property interests. These interests include partnership interests, membership interests in an LLC and shareholder interests in a corporation. These interests are generally considered personal property except in very limited instances such as when the entire entity (not an interest in an entity) is disregarded for federal tax purposes. In general, the entity- partnership, LLC or corporation who owns the property at the entity level is the tax owner of real property, not the taxpayers who merely own interests in such entity which are personal property interests. Investors seeking to perform a 1031 exchange on the sale of assets owned by such entities must ensure that the exchange is to be performed at the entity level. Alternatively, these investors should seek legal/tax advice to determine what steps should be taken to enable the separate investors to independently perform Section 1031 exchanges with their respective interests and what risks may be involved in doing so.

Finally, as indicated above, both what is being sold and what is being purchased must qualify as being held for investment or productive use in a trade or business. For example, purchasing residential replacement property in a Section 1031 exchange and using it as a primary residence or exclusively for personal enjoyment shortly after acquisition will generally disqualify the exchange.

A case demonstrating the above is *Goolsby v. Commissioner*, (April 1, 2010); T.C. Memo 2010-64. Therein, the Court found that the taxpayers intended to use the property as a primary residence from the day of acquisition and there was never the intent to hold for investment. Subsequently, 1031 tax deferral was denied.

In contrast, in a later Tax Court case, *Reesink v. Commissioner*, (April 23, 2012) T.C. Memo 2012-118, a residential property was purchased and converted to a primary residence 8 months after the exchange was completed. Notwithstanding, the Tax Court found that the taxpayers intended to hold the rental property for investment at the time of the 1031 exchange.

Every taxpayer should make significant and meaningful efforts to treat a replacement property acquired in a 1031 exchange as a qualifying property held for investment for a significant time period before converting this property into a residence or any other non-qualifying use. The IRS and Tax Court will look at all of the objective facts and circumstances regarding a 1031 exchange transaction to ascertain the taxpayer's subjective intent at the time of the exchange.

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