FOR INVESTMENT OR FOR SALE?

Most owners of real estate will tell you that if they bought a property for $75,000 and sold it a month later for $100,000, that it was a great investment. If they avoided paying the capital gain tax on their sale by utilizing an IRC §1031 exchange, well they are not just a great investor, but a genius to boot. Unfortunately, that is exactly what the IRS may determine: that the capital gain tax the investor tried to defer is just that, “boot.” The investor will pay ordinary income tax on all of the gain because the asset does not qualify for a §1031 exchange.

What should the investor do so that the sale of his property qualifies for §1031 treatment? The intent by the taxpayer to hold property “primarily for sale” prevents the property from qualifying for tax-deferral treatment. While in general, most properties owned by developers, builders and people looking to fix up and resell will probably be considered to be held “primarily for sale,” the IRS looks to the intent of the taxpayer at the time of the disposition of the property. To qualify for exchange treatment, the taxpayer must have intended to hold the property for investment or for productive use in the taxpayer’s trade or business. Factors that the IRS looks at to determine the presence or absence of a qualified intent include:

1. **The frequency and number of real estate transactions entered into by the taxpayer.**
   The more property sales by the taxpayer, the more likely the IRS will find that the taxpayer is a “dealer,” that the property is “held 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.

2. **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.

3. **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, how long the property was held by the taxpayer prior to sale, is not what determines intent. Rather it is a facts and circumstances test involving a number of factors.

Taxpayers are always advised to consult with their tax and legal advisors regarding the exchange status of a property prior to selling their property.

We, at IPX1031®, pride ourselves on not only being the industry leader in service and security, but we also strive to help our clients and their advisors keep current on tax issues pertaining to §1031 exchanges and applications for them. We aim to be your complete information resource. For more information about us or our complimentary monthly webinars about 1031 exchanges, visit our website at www.ipx1031.com.