

Posted on Sun, Mar. 26, 2006

Be prepared to defend 1031 exchanges made before a two-year period

Q. I read your very enlightening article headlined "Ownership Period Doesn't Effect 1031" wherein you stated there is no minimum period of ownership required for 1031 properties. Could you possibly expand on the article because virtually everything I have read about 1031 exchanges states a property owner should hold the acquired property a minimum of one year and preferably two tax years to avoid problems with the IRS? I am particularly interested in your experience as an expert witness in real estate litigation and arbitration as it relates to this "holding" period and how the IRS views these speedier transactions. I am not interested in "flipping" because I know the IRS' position on that point. However, there have been times when I have held property for the two-year period when I could have sold the properties prior to the expiration of that period, but didn't for fear of an IRS audit. In short, does it come down to the matter of the "intent" of the investor?

A. The intent of the investor in a 1031 tax deferred exchange is a complex matter.

On one hand, the 1031 rules do not require a minimum holding or ownership period for 1031 investment or business property.

On the other hand, an IRS examiner reviewing your tax forms would probably conclude that a real estate investment property should be held for one or two years to appreciate in value and therefore fit their concept of an investment property. Consequently, the IRS examiner would probably call for an audit to determine your intention (business or investment purpose) in owning the property if the property were held for a short time. I have discussed this issue with tax specialists at the IRS who are exceptionally well versed on the legal and practical dimensions of your concerns.

The bottom line is that you should be prepared for an IRS examination which will be a result of the short ownership period.

To be prepared for this examination you will need documentation to support your reasons on why the investment property was held for a short time.

The amount of time that you held the property is only one element of intent. If a good business opportunity arises and you need to sell the 1031 property, this decision reflects that your ownership intent has changed for a good reason.

Other factors that can demonstrate your intent to hold the property as an investment would be a mortgage, letters to equity partners outlining events, corporate minutes or a business plan that reflects the term that the investment will be held.

This being said, the IRS will require documentation on your intent and you will need to be articulate and have documentation to present your case. Good luck.

Q. I have a land option to buy at certain price upon tentative maps approval. Upon approval. I will be selling the land through double escrow. Therefore, will I be able to do 1031? I will have land title for very short time, maybe less than a day. However, I would like to know if I could do 1031 for another land for subdivision, even for apartment, office building or through tenant-in-common format which is been offered by some companies.

A. No. This type of transaction does not qualify for a 1031 tax-deferred exchange. A 1031 tax deferred exchange applies only to investment and business property where the owner sells for a profit and reinvests the proceeds in a higher value property without being taxed on the profit. The fact that you have arranged to sell the property even before the closing negates any intention that you are acquiring the property for investment purposes.

Q. My wife and I purchased a home approximately three ago. Last year we were told after a fireplace and chimney inspection that the chimney top was leaning out four inches compared to the bottom. We were told to replace the whole fireplace and chimney because it was pulling on the existing wall and windows. We replaced the existing fireplace with a new propane fireplace and chimney. Is any of this expense a write-off on taxes or is it just a plus on the value of the home if we sell it?

A. The replacement of the fireplace is classified by the IRS as an improvement that increases the basis you have in your property.

For example, if you paid \$400,000 (basis) for your home three years ago and the only improvement you made was the fireplace for \$30,000, your adjusted basis is \$430,000. There is not a deduction that you can take for the fireplace.

The only immediate tax benefit that may apply would possibility be an energy credit from your local utility. However, do not be surprised if you find that the credit had to be applied for prior to the work being done.

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