

WHAT PROPERTY QUALIFIES FOR IRC §1031 TREATMENT?

To qualify for a tax deferred exchange under IRC §1031 both the relinquished and the replacement properties must be held by the Exchanger for investment purposes or for “productive use in their trade or business”. The Exchanger’s purpose and intent in holding the property, rather than the type of property, is the critical issue. The use of the property by the other parties to the exchange (buyer and/or seller) is irrelevant. The following are examples of qualifying properties:

Bare land	Farmer’s farm
Commercial rental	Residential rental
Industrial property	Doctor’s own office
30-year leasehold interest	Percentage interest in investment property

Under IRC §1031 the following properties do not qualify for exchange purposes:

- Stock in trade or other property held primarily for sale (Note: this includes property held by a developer or other dealers in property);
- Securities or other evidences of indebtedness or interest;
- Stocks, bonds, or notes;
- Certificates of trust or beneficial interests;
- Interests in a partnership (Note: the partnership can elect out of partnership status under IRC §761(a));
- Choses in action (this is a right to receive money or other personal property by judicial proceeding).

It is important to note that the intent by the Exchanger to hold the property for personal use will prevent the property from qualifying for exchange treatment. Therefore, second homes will not qualify for tax deferred exchange treatment unless the taxpayer changes how they treat or use the second home. For example, a taxpayer could “convert” their second home to a valid exchange property and establish this intent by properly renting the property and holding it as a legitimate rental property. See Rev. Rul. 57-244, 1957-1 C.B. 247. However, the taxpayer cannot just simply rent the taxpayer’s residence and expect it to automatically qualify for exchange treatment. *Bolaris v. C.I.R.*, 776 F.2d 1428 (9th Cir. 1985). Many taxpayers own vacation homes, which are rented out during the time when the taxpayer is not using the home. Even though under IRC §280A a vacation home may have a portion of its deductions disallowed if it is used for personal purposes under the “14-day rule”, an Exchanger can argue that if the vacation home is partially used in a trade or business (renting it), the vacation home should be eligible for tax deferred exchange treatment upon its sale. However, there may need to be a bifurcation of uses as is also required for a home office use in a personal residence. Rev. Rul. 82-26, 1982-1 C.B. 115.

In many instances taxpayers use a part of their personal residence for a home office for business purposes. In this case when the taxpayer sells the personal residence, the transaction must be split such that the portion used for business purposes is treated separately for tax purposes from the portion used for a personal residence. Rev. Rul. 82-26, 1982-1 C.B. 115. The taxpayer could then qualify the entire transfer for tax-free treatment; the business portion could qualify for a tax deferred exchange under IRC §1031 and the personal residence portion could qualify for a tax-free sale under IRC §121 provided the transaction otherwise met the exemption requirements of IRC §121. Naturally, consultation with a tax advisor is important whenever a taxpayer changes how they intend to hold property.

Brief Exchange Communications

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