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Holding period requirements in a 1031 exchange: Not just a matter of time. Intent is key.

July 27, 2015 - New York City

Property must be "held" for investment or business use (a "qualified purpose") in a 1031 tax-deferred exchange. This requirement applies to property being sold to start an exchange, as well as property acquired as replacement in an exchange. The length of a holding period is often cited by exchanging taxpayers to satisfy the qualified use requirement, but time is just one factor that the IRS and courts will consider in determining the taxpayer's intent. Though the Internal Revenue Code and Treasury Regulations are silent on this issue, a careful analysis of IRS rulings and case law yields some principles that can be stated with certainty.

First, the IRS has issued several rulings stating that if the property a taxpayer seeks to exchange was acquired immediately before the attempted exchange, then the taxpayer will be viewed as having acquired that property primarily to resell for profit, not for investment or business use (see Revenue Rulings 84-121, 77-337, and 57-244). The IRS has also taken the position that if replacement property is disposed of immediately after the exchange, the property would not be viewed as being held for a qualified purpose under IRC section 1031 (see Revenue Ruling 75-292). Courts have been more liberal on the issue of how long a taxpayer must hold a relinquished property to prove investment intent (See 124 Front Street Inc. v. Commissioner, 65 T.C. 6, 1975), but tend to agree with the IRS on disqualifying an exchange when the replacement property is disposed of soon after acquisition (see Black v. C.I.R. 35 T.C. 90, 1960).

In Private Letter Ruling 8429039 (1984), the IRS stated that a holding period of two years would be a "sufficient" period of time for the property to be considered held for investment. Though private letter rulings do not constitute binding precedent, some tax advisors believe that two years is an adequate holding period, assuming that the investor not only held the property for two years, but that he intended to do so for investment purposes.

Some tax advisors believe that one year is also a sufficient holding period. First, if investment property is held for 12 months or more, the investor's tax returns will reflect this fact in two tax filing years. Second, in 1989, through HR 3150, congress had proposed that both the relinquished and replacement properties be held for one year to qualify for tax-deferred treatment. Though this timeline was just a proposal, and it was never incorporated into the tax code, some tax advisors nevertheless believe that it represents a reasonable minimum guideline.

The differing opinions of the IRS, courts and legislature reveal that the determination of whether a property is held for investment will be made on a case-by-case basis, taking into consideration all of the facts and circumstances that apply to the taxpayer's particular situation. If audited, the taxpayer will have the burden of proving that his "intent," when he purchased the replacement property, or came into title in the relinquished property, was to hold the property for investment or business use. But, a taxpayer's purpose can change while he holds the property (See Reesink v. Commissioner, TC Memo 2012-118). In general, the longer a taxpayer holds property, the easier it will be to prove investment intent, but courts have approved of exchanges when the relinquished property was held for only five days (See Allegheny County Auto Mart v. C.I.R. 208 F2d 693, 1953) and when the replacement property was converted to personal use after only eight months (See Reesink, supra). Courts have disapproved of exchanges when the replacement property was held for six years (Klarkowski v. Commissioner, TC Memo 1965-328, aff'd on other grounds (7th Cir. 1967) 385 F2d 398).

Though IRS and court rulings will differ in each transaction depending upon specific circumstances, a taxpayer can increase the chances of surviving an IRS audit if the intent to complete a 1031 tax-deferred exchange is documented as soon as possible. A qualified intermediary, in conjunction with a competent real estate agent and tax advisor, can help the exchanger create a "paper trail" of intent to ensure a successful exchange.

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