HOW TO DETERMINE WHAT TYPE OF PROPERTY QUALIFIES FOR A § 1031 EXCHANGE

No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be either for productive use in a trade or business or for investment.

Under the Regulations, the following properties do not qualify for exchange purposes:

- Stock in trade or other property held primarily for sale
- Stocks, bonds, or notes;
- Other securities or other evidences of indebtedness or interest;
- Interests in a partnership;
- Certificates of trust or beneficial interests; or
- Choses in action.

In general, if property is not specifically excluded, it can qualify for tax-deferred treatment.

The Exchangor's purpose and intent in holding the property will generally be determinative as to whether §1031 can be utilized for investment properties which are used by the Exchangor for personal use, however significant personal use of a property will compromise the claim of a property being held "primarily" for investment. A recent case (Barry E. Moore v. Commissioner, *TC Memo. 2007-134; No. 11002-03* May 30, 2007) disallowed an exchange where the Exchangor claimed investment treatment for a property. A complex issue; guidance should be sought from the Exchangor's tax professional. Guidance can be sought from IRC §280 as to classification of a vacation/investment property, however those rules are not directly applicable or determinative as to the classification under §1031. Common sense must be liberally applied in this instance.

Another issue arises as to whether property owned by the Exchangor is held for sale or inventory. Looking to the nature, extent and sales history of other properties owned by the Exchangor is helpful. Also, a clear intent of the Exchangor to hold property "primarily for sale" will prohibit the property from qualifying for IRC §1031 treatment. While there are no specific guidelines for classifying whether property is held for inventory or for investment, the courts do seem to agree that the more transactions the Exchangor has engaged in with a particular type of property, the more likely the court will find that the property is "held for sale" and does not qualify for exchange treatment.

Properties can be converted from investment to personal use, and vice versa, to benefit from other deferment or exclusions under the Internal Revenue Code. For example, a taxpayer could "convert" their second home to an investment property and establish this intent by renting the property and holding it as investment for a sufficient time to change its classification for purposes of §1031. However, the Exchangor cannot just simply rent the Exchangor's residence and expect it to automatically qualify for exchange treatment. Revenue Procedure 2005-14 outlines and tacitly approves of conversion of a property acquired under a tax deferred exchange to residential use at a later time. For a party seeking to purchase a replacement property with the long term goal of converting it to their primary residence, this can be a powerful tool for tax planning.

Properties can also have "split" uses. In many instances taxpayers use a part of their primary residence as a home office for business purposes. In this case when the Exchangor sells the primary 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 primary residence. The Exchangor 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 primary 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.

Examples of qualifying real property interests are: unimproved land held for investment; property held for rental; a medical legal accounting or other professional office; land farmed or mined; leasehold interests for a term of thirty years or more . If there is a question regarding applicability of a particular property, please call Attorneys & Accountants 1031 Services, LLC or your legal advisor for further guidance.