

## 1031 Exchange Concerns

### Dealer Status:

A dealer is a person who acquires real estate for resale or as inventory. For example, a dealer subdivides acres into multiple lots, improves and then sells! Or, buys a fixer-upper, and sells quickly after improvements are completed.

Remember...there is an IRC Section 1031 exception stating that “stock in trade or other property held primarily for sale” do not qualify for 1031 treatment.

*Solution?* Hold the property for investment purpose – rent the property out!

### Second Homes or Vacation Homes:

IRC Section 1031 states that property is not eligible for non-recognition treatment unless it is held by a taxpayer for productive use in a trade or business or for investment purposes. However, many taxpayers have difficulty determining whether or not a property is an investment home or a second/vacation home. What does “held for investment” mean?

- IRC Section 280A governs the allowance of deductions from dwelling units, and it provides that a taxpayer uses a dwelling unit as a residence if the taxpayer uses the unit for personal purposes for more than 14 days, or 10% of the number of days during the year for which such dwelling unit is rented for fair market value. This tax section also states that personal use of the property includes use by a family member, by an individual who uses the unit under an arrangement that enables the taxpayer to use some other dwelling, or by any individual if the unit is rented for less than fair rental value.
- The Rev. Proc. 2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. It states that a dwelling unit qualifies as relinquished/replacement property in an exchange if it is owned by the taxpayer for at least 24 months immediately before/after the exchange and in this period the taxpayer rents the property for at least 14 days or more and the personal use of the relinquished property does not exceed the greater of 14 days or 10% of the number of days during the year that the relinquished property is rented at a fair rental.

*Solution?* A taxpayer who wants to exchange a vacation home under IRC Section 1031 should not exceed the personal use limits of IRC Section 280A and should rent the property for fair market rent for 14 days or more in the 24-month period before exchanging.

### Sales contracts:

Bona fide intent – What is exchangor’s intent at time of sale/purchase? The exchangor should show their intent to participate in a 1031 at the time a sales contract is entered into.

*Solution?* Show intent on earnest money agreement.

The “Cooperation Clause” serves the purpose of disclosing the exchange. It also gives a basis for requiring the buyer/seller to cooperate with the exchange. Here is some sample language:

- Buyer hereby acknowledges that it is the intention of the seller to complete an IRC 1031 exchange, which will not delay the close of escrow or cause additional expense to the buyer. The seller’s rights and obligations under this agreement may be assigned to an Intermediary of the seller’s choice for the purpose of completing such an

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exchange. Buyer agrees to cooperate with the seller and the Intermediary in a manner necessary to complete the exchange.

- Seller hereby acknowledges that it is the intention of the buyer to complete an IRC 1031 exchange, which will not delay the close of escrow or cause additional expense to the seller. The buyer's rights and obligations under this agreement may be assigned to an Intermediary in a manner necessary to complete the exchange.

#### **Related Parties:**

Many taxpayers may attempt to exchange when a transaction involves a related party, which may not be a good structure for their exchange. Related parties include: spouse, children, grandchildren, parents, siblings, a corporation or partnership where the exchangor has more than 50% ownership interest and trust beneficiaries. IRC Section 1031(f)(1)(C) requires that "the property received in a related party exchange, by exchangor or related party, be held for two years after the date of the last transfer which was part of the exchange." Regardless of the holding time of exchanged property, the IRS has disallowed the purchase of replacement property from a related party in Revenue Ruling 2002-83. However, if the related party is not cashing out (if the seller is also exchanging), this ruling does not apply.

*Solution?* As long as the property is held for two years, the following related party exchanges have been approved:

- An Exchange when parties directly swap properties with one another.
- A Sale of relinquished property to a related party.
- A Purchase from a related party when the seller does not cash out (exchanges for both parties).

Who is not considered a related party? In-laws, aunts, uncles, nieces, nephews, friends, domestic partners, entity where exchangor has <50% ownership interests, ex-spouses

When considering exchanging with a related party, particular caution should be taken. Please consult with your attorney and/or CPA to ensure that there are no unintended tax consequences.

#### **Cash:**

Once cash is deposited into an exchange value account, it cannot be touched throughout the exchange period. If the exchangor wants to have a partially deferred sale, funds should be taken at close of escrow, rather than sent to the Qualified Intermediary. Once funds are deposited into the exchange value account, they cannot be released to the exchangor. If cash is taken, a taxable event will occur, as the taxpayer has received "boot."

*Solution?* To avoid the taxable boot, the exchangor can opt to refinance after the exchange transaction is complete rather than taking cash out of the sale proceeds.

#### **Creating an exchange:**

Although there may be a Cooperation Clause on the earnest money agreement, the exchangor or their agent should notify the Qualified Intermediary that a sale or purchase has opened. If the Qualified Intermediary has contact information for the escrow agent, including an escrow number, this will help to ensure that the exchange documents and instructions are with the settlement agent in time.

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