



First American  
Title Insurance Company



# Escrow Tip

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**SUBJECT:** Mind Reading 101: How the IRS Gets into Your Head to Determine if Your Sale Qualifies for Tax Deferral

Most owners of real estate will tell you that if they bought a property for \$75,000 and sold it a month or two later for \$100,000, that it was a great **investment**. If they also deferred paying taxes by doing a **1031 exchange**, they may be considered a genius! However, the IRS would not consider this to be an act of genius; it would be very likely to determine their **1031 exchange** was invalid because they sold inventory and would assess taxes, interest and penalties.

So, what should an investor do to ensure the sale qualifies for tax deferral under section 1031?

The intent by the taxpayer to hold property "primarily for sale" and not "primarily for investment" will prevent the property from qualifying for **1031** treatment. While in general, most properties owned by builders, developers and people intending to fix up and resell them will be considered to be held primarily for sale (and not entitled to deferral under section **1031**), the IRS will look at the intent at the time of sale. In order to qualify for a **1031 exchange**, the Exchanger must be determined to have held the property for either productive use in a trade or business or for investment ("qualified use"). Here are a couple of factors that the IRS will look at that can determine the taxpayer's property was "held for sale" and does not qualify for a **1031** exchange.

1. The frequency and number of real estate transactions entered into.

The more property sales by the **Exchanger**, the more likely the IRS will consider that the property is "held for sale" and does not qualify for **1031** treatment. An example of this is the person who buys foreclosed/distressed properties, fixes them up and then immediately attempts to sell (flip) them for a quick profit.

2. The nature and extent of efforts by the taxpayer to sell the property.

This relates to the sales efforts of the taxpayer and includes advertising efforts, use of sales personnel, etc. The IRS will look at the proportion of the **Exchanger's** income that is derived from the sale of the property, and the extent of the taxpayer's involvement, time, effort and control over the sales activities regarding the property.

**Source:** Contact Investment Property Exchange Services, Inc.

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