

1031 Exchange Holding Period Requirements

When asking about 1031 Exchange requirements and then considering a 1031 Exchange, people often wonder what the 1031 Exchange time limit is in relation to how long you have to hold the property before and after an exchange for it to qualify. In the article below we cover that very question at length.

How Long Does a Property Need to Be Held to Satisfy the 1031 "Held For" Requirement?

Most of the rules and regulations pertaining to IRC Code Section 1031 are found in the detailed Treasury Regulations supporting the Code. However, the requirement that exchange assets be held for use in a business or for investment have been part of Section 1031 itself since the inception of this provision in the 1920s.

“No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment”

As can be seen this excerpt from the Code, this provision applies to both the Relinquished Property and the Replacement Property. This seemingly simple word, “held,” often comes into play in connection with persons trying to determine if their facts will allow for a successful real estate exchange. This requirement often causes confusion for Exchangers and their advisors. A great number of people, including professional advisors, tend to equate it to the necessary time period of one year to convert a gain on the sale of an asset from ordinary income to capital gain treatment. However logical it may seem, in reality there is no connection between the “held for” requirement under IRC 1031 and the time period to create a capital gain.

Facts and Circumstances Will Determine a Satisfactory Holding Period

Most exchange expert commentators take the position that a holding of two years or more is so significant an amount of time that it would satisfy the holding period requirement. A revenue ruling was issued by the IRS in 2008 in connection with vacation properties that once were held for personal use but have been converted to use as an investment. In this somewhat analogous case, the IRS provided a “safe harbor” stating that in order to treat the property as an investment, it had to be held in that capacity for at least 24 months immediately prior to an intended exchange.

However, the holding period question usually involves time periods of less than two years. Rather than a bright line rule, such transactions require a facts and circumstances test to determine a satisfactory holding period.

1031 Exchange Holding Period Examples

Let's look at a few examples. Perhaps the question most often asked of a Qualified Intermediary pertains to situations in which fewer than all members of a limited liability company or partnership wish to complete an exchange of Relinquished Property. Sometime prior to the sale, the limited liability company or partnership distributes undivided interests to each of the members or partners and then each one seeks to do his or her own exchange, while others cash out. This is generally known as a "Drop and Swap." Unfortunately, the individual's prior ownership interest, as a member or partner in the original entity, does not count towards their new individual ownership, and as a result they cannot be said to have held the property for use in a business or trade. Not only did they hold it for a short period, but they also held it in connection with an intended exchange rather than as an investment.

In contradistinction is the case of an Exchanger selling an investment property and trading into another investment property. In a short period of time, someone knocks on his door and makes him a very attractive offer to sell this replacement property. The facts and circumstances indicate that the Exchanger bought the property with the intent to hold it as an investment. The Exchanger put a tenant into the property (or actively advertised for a tenant) and did not put the property up for sale personally or through a listing real estate broker. Despite the short ownership period, taking advantage of this "offer too good to be true" should allow the Exchanger to exchange this property and roll all the deferred gain into a new property.

As a final example, let's look at a builder who commonly builds General Dollar stores and sells them upon completion. However, in our example, the builder decides to keep one store and holds it for a few years and then puts it up for sale with the intent to do an exchange. As a rule of thumb, dealers, flippers, rehabbers, etc. buy or build on property with the intent to sell the completed project. Since the held for requirement pertains to the asset and not to the Exchanger or their typical line of work, the builder in this example should be able to do an exchange. Keep in mind, however, that this property would have to be traded for another investment property rather than one that would be intended to be sold.

Summary

Under the exchange rules, relinquished and replacement assets need to be held by an Exchanger for investment or for use in a business or trade. The amount of time that an asset must be owned to be able to claim that it was "held" is not a matter of a specific rule, rather it is based upon the facts and circumstances surrounding the disposition and acquisition of the properties.