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## Shades of Gray in 1031 Flips

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Forget cooking shows, America's newest reality show obsession is watching real estate shows such as *Flip This House*, *Flip or Flop*, and *Rehab Addict*. Seeing how a house is bought at a bargain price, quickly transformed and sold for large profits can be scintillating. In fact, it can entice many to try their hand at flipping properties. A big question often encountered is whether profits earned from a flipped property can be used, tax deferred, to purchase the next fixer-upper by structuring the purchase as a 1031 Exchange?

To qualify for tax deferral under section 1031, the property must be "held for" investment or to own the property for the taxpayer's trade or business ("a qualifying purpose"). This "held for" requirement is not purely black and white. Rather it contains shades of gray.

To help understand the "held for" requirement, the two words

“principal intent” are crucial. If the property was acquired with the *principal intent to sell*, like most flipped properties are, then the property is considered to be inventory and **will not** be eligible for tax-deferral under section 1031. The goal for most people acquiring property to rehab and thus intent, is for a quick sale and profit, not for an investment or business purpose. Therefore, instead of being able to use all of their profits, tax-deferred to purchase the next property, profits will be taxed as ordinary income.

However if somebody buys a property to fix up to rent, then the principal intent is *to own the property for trade or business* - the business of renting. This qualifies as a proper use for section 1031 purposes. Likewise, if they acquire vacant land with the intent to hold the property for future appreciation, this qualifies as an investment use for 1031 purposes.

There are other important factors considered by the courts. These can include length of time before selling, why the property was purchased, how the property was used, what improvements were made to the property, the taxpayer’s ordinary business and number of prior sales (are their actions consistent with investing or selling inventory), and how the property was being used when sold. There is no one single factor that will prevail. Rather, courts tend to look at all of the facts to determine whether the taxpayer held the property for a qualifying purpose.

Flips can be lucrative and create a reward of a quick profit. However with most flips, you will be paying taxes at ordinary income tax rates. If your intent is for business or investment and you meet certain criteria, then your property may qualify for 1031 treatment. In areas of gray, consider the benefits of a 1031 compared to the potential costs of an IRS audit, interest and penalties compared to paying taxes due. Talk to your tax or legal advisor to review your individual circumstances.



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