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Lee David Medinets, Esq.

**Residential Property
and §1031 Exchanges**

When investment property is sold, capital gains taxes must generally be paid on any gain realized. With a §1031 Exchange, however, investors are allowed by the IRS to postpone paying these taxes. This subsection of the Tax Code states that “no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business, or for investment.” In addition to maintaining greater net profits for reinvestment, investors can use a §1031 Exchange to shift an investment from one geographic region to another, trade older properties for newer ones to avoid deferred maintenance expenses and diversify a real estate portfolio.

The IRS stipulates a number of requirements for a valid §1031 Exchange. Property owners must trade one or more relinquished properties for one or more replacement properties of “like-kind.” The replacement property cannot have been acquired for immediate resale, nor can it be the taxpayer’s personal residence. However, it is the facts and circumstances of each transaction that determine whether a property is held for investment, rather than for personal use. Many have recommended that – to be on the safe side – taxpayers should

hold the replacement property for at least two years before converting it to personal use, and should make significant efforts during that time to use it for investment purposes.

In the recent case of *Reesink vs. C.I.R.*, T.C. Memo 2012-118, No. 2475-10 (April 23, 2012), the U.S. Tax Court has taken steps to better distinguish the holding purpose for residential property. In this case, the Court considered whether a single-family house was acquired by the taxpayers as a personal residence or as an investment.

In 2005, Mr. and Mrs. Reesink sold a 50 percent TIC interest in a San Francisco apartment building for the gross sales price of \$700,000. They used the net proceeds a little over one month later to acquire a single-family house and a vacant lot in Guerneville, CA. Their mortgage loan application

indicated that the property was purchased as an investment. “For Rent” signs were posted on the property. Flyers were distributed throughout Guerneville advertising the property for rent. Two prospective tenants examined the property to consider leasing it, but each decided that they could not afford the asking price of \$3,000 per month. The taxpayers never lowered their asking price, and the property was never advertised for rent in any local newspaper. The court did not say if the property was ever listed for rent with a real estate broker, although the taxpayers consulted with one.

After failing to rent the Guerneville property for some time, Mr. Reesink wanted to sell the couple’s home in San Francisco because they could not afford the carrying costs of all the real estate that they owned. Mrs. Reesink resisted this idea because she liked living in San Francisco and because she did

not want to take their son out of his current high school. Nevertheless, the couple listed their home in San Francisco in April, 2006, about six months after they acquired the Guerneville property. At that time, they considered either moving to Guerneville or moving in with Mr. Reesink’s sister. Two months later, when their San Francisco home was sold, they elected to move to Guerneville. That was almost eight months after they acquired the Guerneville property. Until they moved in, they had never stayed in the Guerneville property or used it for any personal purpose.

On these facts, the court found that the Reesinks’ principal intention in acquiring the Guerneville property was for investment, not personal use. The court stated that perhaps the strongest evidence of the Reesinks’ investment intent came from Mr. Reesink’s estranged brother, a witness for the IRS, who testified that Mr. Reesink told him on several occasions that they planned to move to the Guerneville property after their son graduated from high school. That would have been significantly more than two years after they acquired the Guerneville property. This testimony gave weight to the position of the taxpayers that they had changed their minds because of financial difficulties when they decided to move to Guerneville in 2006.

In concluding that the taxpayers had satisfied their burden of proving that they purchased the Guerneville property principally for investment, the court distinguished this case from *Goolsby v. Commissioner*, T.C. Memo. 2010-64. In *Goolsby*, the Tax Court found that the taxpayers did not have a bona fide investment intention when they acquired the replacement property. In



Reesink, the court pointed out that in Goolsby (a) the taxpayers made the purchase of the replacement property contingent on the sale of their home; (b) they sought advice concerning when they could move into the replacement property; (c) their rental efforts consisted solely of placing one advertisement in a local newspaper; (d) they began refinishing the basement of the replacement property within two weeks of acquiring it; and (e) they moved into the replacement property within two months of acquiring it.

Goolsby and Reesink help to define the burden of proof that taxpayers will be expected to meet if they move into a replacement property before
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the end of the recommended two-year holding period. The two cases do not yet suggest a bright line test, but at least they clarify some of the distinctions regarding the use of §1031 Exchanges for residential properties.

Lee David Medinets, Esq.
is senior counsel for Madison §1031. ■