

## **The IRS Has Provided a “Safe Harbor” but Little Guidance for the Exchange of Residential Properties**

A number of years ago, I read an article written by a colleague and friend of mine. In the article, he said that the question he is asked most often is whether it is possible to perform an IRC § 1031 like-kind exchange on a vacation home. Can you, say, make a tax-deferred trade of a ski chalet for a beach house? This has never been nearly as common a question for me as it is for him, but it comes up often enough, and it is an important question. I thought of my friend and his article when I read the new “safe harbor” rules covering this type of exchange that were recently issued by IRS.

Here is the problem: IRC § 1031(a)(1) states (slightly paraphrased) that no gain or loss will be recognized when property *held for productive use in a trade or business or for investment* is exchanged for property of like kind which is to be *held either for productive use in a trade or business or for investment*. The phrase, “held for productive use in a trade or business or for investment,” is the so-called “holding requirement” of IRC § 1031. If property is held for any other purpose, it fails the holding requirement. Examples of inappropriate holding purposes include property held for personal use, property held to be used as a gift and property acquired and held for the purpose of an immediate sale.

If property is held for multiple purposes, some of which meet the holding requirement and some of which do not, then the tricky question is, what was the *primary* purpose of holding the property? A vacation home is a great example of property that may be held for multiple purposes. Sometimes the taxpayer rents it out. Sometimes his family uses it. Sometimes he lets Cousin Larry use it if Larry pays for the utilities and any damage caused by his kids. Maybe the taxpayer uses the property to build business relationships or to close deals or to reward successful sales reps. The taxpayer might have bought the property because it’s a great place to get away from it all. On the other hand, maybe she thought that this would be a smart place to sock away some extra cash.

The answer to the question of what is the primary holding purpose for any given property is written only in the heart of the taxpayer. Unfortunately, the heart is a hard thing to read and even harder to introduce into evidence. Therefore, the law is that *the taxpayer has the burden of proving his or her intent through external evidence*. This means that whenever the taxpayer's intent is questioned, the law presumes that the taxpayer's primary holding purpose was *inappropriate*, and it is up to the taxpayer to rebut that presumption by the majority of the evidence.

In the case of a vacation home, external evidence would include factors such as the number of days during the year that the property was used for family purposes, the number of days that it was rented, whether the property is listed with a broker as a rental property, whether it was advertised, whether books and records were kept in a business-like fashion, whether the taxpayer demanded market rates for renting the property, what sort of market research the taxpayer did before purchasing the property, and so on.

Although the factors to consider are fairly clear, there has been very little practical guidance to help a taxpayer figure out where the line actually is drawn. As a result, overly aggressive taxpayers tend to claim nearly any property that isn't their principal residence<sup>1</sup> as being held primarily as an investment, while overly cautious taxpayers tend to forego this important tax deferral opportunity in all but the most obvious cases. Not surprisingly, the few reported cases<sup>2</sup> have dealt with the most aggressive (and least defensible) attempts to claim a property as an investment. Results for the taxpayers in those cases have been predictably unsatisfactory, and little guidance can be gleaned from them.

A more useful source for guidance has been IRC § 280A. That section controls (among other related cases) whether a taxpayer can take depreciation and deduct

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<sup>1</sup> I have known more than one taxpayer who actually wanted to claim their home as an investment. After all, they were making a lot of money by selling it. There are actually a few cases where that argument flies, but that is beyond the scope of this article.

<sup>2</sup> E.g. *Moore v. CIR*, T.C. Memo 2007-134 (US Tax Court, 2007).

expenses for a property that was used, in part, as the taxpayer's residence and used, in part, as a rental property. For our purposes, the interesting part of this statute is Subsection (d). It provides that a property is considered to be the taxpayer's residence – and therefore non-deductible – if the taxpayer used the property for more than 14 days during the year or 10% of the days that the property was rented at fair market rent (whichever is greater). There are some twists to this rule. For example, use of the property for the purpose of maintaining it does not count as personal use. On the other hand, use of the property by a spouse, ancestor, sibling or descendant of the taxpayer is considered to be the equivalent of personal use unless the family member meets a two prong test: They must pay fair market rent and the property must be their principal residence. Any time that the taxpayer allows someone to use the property without paying fair market rent, it is counted as personal use by the taxpayer. (Sorry, Cousin Larry, honestly, we'd love to let you stay for free, but we can't afford to take the tax hit.) Swapping a week in your house for a week in someone else's house also counts as personal use.

Two cases are worth special mention: First, under IRC § 280A, a taxpayer can deduct as business expenses maintenance and depreciation for a property that he uses 14 days per year, so long as the property isn't used by anyone at all during the rest of the year. Second, a taxpayer *can* deduct businesses expenses for a property rented to a close family member at fair market rent, so long as the property is that family member's principal residence.

Before the IRS's recent Revenue Procedure on the subject, most IRC § 1031 practitioners have presumed that any property that qualifies for business expense treatment under IRC § 280A is *very likely* (though, perhaps not certain) to qualify as a property held for investment under § 1031(a). One area of possible conflict between the requirements of IRC 1031 and IRC 280A is demonstrated in the example of a ski chalet that is used only two weeks per year. The taxpayer may not be getting full benefit out of

the property but it is nonetheless a little hard to claim that the property is primarily an investment as required by IRC 1031.

Admittedly, some such properties ought to qualify as investments and should therefore qualify for like-kind tax deferral. What if the taxpayers could show that they extensively researched the potential for appreciation in the ski chalet market and that they had identified this property as being likely to increase in value 40% over the next four years, provided that the property was kept in relatively pristine condition? Perhaps they can prove this from correspondence that they had with their real estate broker, attorney, accountant and financial analyst. The taxpayers, let's say, go skiing seven weekends per winter (two days, each – not more, and without children or pets, of course – Don't want to damage the woodwork and carpets). They also spend three days there in late fall, polishing the mahogany and getting the property ready for winter, and two more days in early spring, closing the property for the summer and putting up the shutters. When these taxpayers show their research and projections and correspondence and maintenance books, and their eventual sales price slightly exceeds their projections, and they have excellent alibis for every other weekend during the year, my guess has always been that their exchange would be upheld on audit.

Thanks to Revenue Procedure 2008-16, this is no longer just an optimistic speculation.

IRS Revenue Procedure 2008-16 creates a "safe harbor" when a "dwelling unit" is used as either the relinquished property or as the replacement property in a like-kind exchange made pursuant to IRC § 1031. When the procedures of the Revenue Procedure are complied with, the IRS will not challenge whether the dwelling unit was held for productive use in business or trade or for an investment.

For relinquished property, the property must have been owned by the taxpayer for not less than two years prior to the exchange. During each of two 12-month periods immediately preceding the exchange, the taxpayer cannot have used the property for

more than 14 days or 10% of the days during that 12-month period that the property was rented at fair market value. The same general test applies to replacement property. However, in the case of replacement property, the test is applied (reasonably enough) to the 24 months *following* the exchange.

The new Revenue Procedure follows standards set by IRC § 280A. Use of the property by anyone for less than fair market rent is considered personal use. Use of the property by a third-party in exchange for timesharing use of some other property is considered personal use. Use of the property by a spouse, ancestor, sibling or descendant is considered personal use, even at fair market rents, except if the property is the principal residence of the family member and they are paying fair market rent.

The most important difference between the standard of IRC § 280A and Rev. Proc. 2008-16 is that the Revenue Procedure requires that the property be held by the taxpayer for two years (prior to sale or after purchase) and that it pass the maximum personal use test for that entire period. The statute has no such requirement. The real news about the Revenue Procedure is how little news there is *in* the Revenue Procedure. If a taxpayer has owned a property and she has rented it out and has used it only nominally for any personal use, and she qualified for business tax deductions for expenses of maintaining the property, few tax practitioners would be surprised that the property qualifies as an investment property for a like-kind exchange.

One small piece of news in the revenue procedure is for taxpayers who rent property to their close family members. As long as the property is the principal residence of the family member, and as long as they can justify the rent as being fair market under the circumstances, and as long as the taxpayers continue to hold the property in that condition for at least two years, then they have no worry that they will be found to have held the property for personal use – unless, of course, they come visit for more than 35 days per year. (That may or may not be good news to the family members. I take no position on that issue.)

The other good news is for our friends who own the ski chalet. As long as they can control within limits their urge to ski, they can now be confident that they will be able to exchange that property for a seaside villa, as soon as mountain top properties peak and ocean front properties hit bottom.

The bad news is for my friend and for me. We still don't know how to advise our clients with real vacation home problems. There is bad news for Cousin Larry, too. I've still got to charge him market rents. I'd love to help, but I can't afford to risk my exchange. Look – here is the Revenue Ruling.