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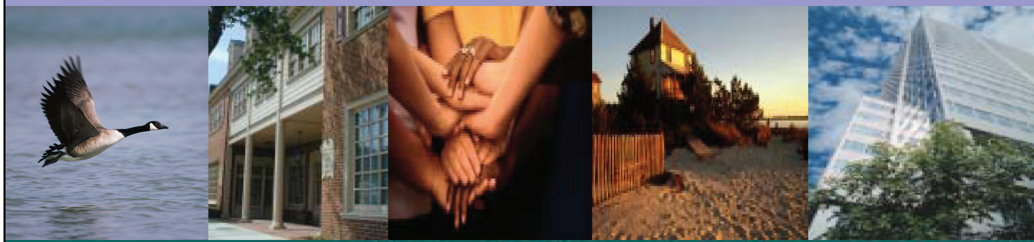
The Exchange



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About the Author

Anna Gregory Wagoner grew up in Salisbury, North Carolina. She graduated from Wake Forest University in 1994 with a Bachelor of Arts in Psychology. Anna Gregory continued her education at Wake Forest, receiving her Juris Doctor from the School of Law in 1999. Prior to joining Investors Title, Anna Gregory worked as a real estate associate with Isaacson, Isaacson, & Sheridan, LLP for four years. She has also worked on real estate issues for a large corporation and has experience as a title attorney. Anna Gregory is a member of the North Carolina Bar Association. She is also a member of the Raleigh Jaycees. Anna Gregory joined ITEC in February, 2006.

The IRS Issues A Safe-Harbor For Residential Dwellings

By Anna Gregory Wagoner, Esq.

Until recently, there has been no specific guidance from the IRS as to whether or not vacation homes qualify for 1031 exchange treatment. In May, 2007, the Tax Court issued a ruling in the case of *Barry E. Moore et ux v. Commissioner* that provided the most comprehensive discussion of vacation homes to date.[1] In that case, the taxpayers had owned a lake house for 12 years. During the first few years the taxpayers used the house frequently but then moved away and did not use the house very often for several years. The taxpayers exchanged the lake house for another lake house that they also used personally, but argued that both houses were held for investment. The tax court found that the primary use of the property should control the "held for investment" test and that in this case the primary use was personal, and therefore; the property did not qualify for 1031 treatment. In the *Moore* case, the court considered the following factors in making their determination:

- The primary use of the property was for personal use;
- The taxpayers never rented or tried to rent the house;
- The taxpayers did not keep the house well-maintained after moving away;
- The taxpayers did not deduct maintenance expenses or depreciation on their tax returns;
- The taxpayers treated all mortgage deductions as a 2nd home mortgage on their tax returns;
- The mere hope of appreciation does not show an investment intent.

This case was the only guidance issued on the treatment of vacation homes until the IRS issued Revenue Procedure 2008-16, which went into effect on March 10, 2008. This Revenue Procedure went much further than just addressing the qualification of vacation homes in an exchange and set forth a safe-harbor under which the qualification of any residential unit for 1031 exchange treatment will not be challenged by the IRS. Under this procedure a residential unit will qualify as investment property if the following standards are met:

- The relinquished property must have been owned by the taxpayer for at least 2 years preceding the exchange; and
- Within those 2 years, the taxpayer must have rented the property out at fair market rental for at least 14 days each year; and
- The taxpayer's personal use must not have exceeded the greater of 14 days or 10% of the number of days rented each year.

The same rules apply to the replacement property, which must be owned by the taxpayer for at least 2 years following the exchange. If the taxpayer's use of the replacement property does not comply with the safe-harbor, the taxpayer must go back and file an amended tax return and treat the transaction as taxable sale rather than an exchange.

Taxpayers should note that this Revenue Procedure broadly defines "personal use". Use by any of the following people will be held to be personal use by the taxpayer: the taxpayer or any other person who has an interest in the unit (such as a co-owner); any family member of the taxpayer or such other person; any individual who uses the unit under an arrangement which enables the taxpayer to use

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The IRS Issues (continued)

some other dwelling unit (whether or not a rental is charged for the use of such other unit); or any person if the unit is rented for less than fair market rental. A taxpayer may rent the unit to a family member to be used as that person's principal residence so long as fair market rent is paid, and the rental will not be considered personal use by the taxpayer. The taxpayer is also allowed to use the unit while making repairs or doing maintenance to the unit, but he must be able to prove that he actually did work on the unit.

It is important to note that while this revenue procedure is being referred to as the vacation home safe-harbor, it actually applies to any residential unit that is relinquished or replacement property in an exchange. This does; however, present an excellent planning opportunity for those who currently own personal use property (even a principal residence) and want to convert it to eligible exchange property. All a taxpayer would need to do is own the personal use property for at least two years, rent it out at fair market value for 14 days each year, limit their own personal use of the property to 14 days a year or 10% of the rental period, and then sell it in an exchange, with no questions asked. A taxpayer could do the same with replacement property for two years following the exchange. If the taxpayer wanted to use the unit as his principal residence in the future and eventually take the Section 121 personal residence exemption, he must own the property for at least 5 years and live in the property as a principal residence for at least two out of the 5 years preceding the sale to exclude gain recognition under Section 121. Section 121 was again modified, effective January 1, 2009. If the taxpayer sells the property in the future, after qualifying for the 121 exclusion of gain as discussed above, he must prorate the gain as to the time he has owned it for rental or other use versus as a principal residence, and he may only exclude the prorated portion of gain that applies to his use as a principal residence. So, if the taxpayer rents the property out for the first 2 years following the purchase, per the terms of the safe-harbor, and then lives in it for the next 8 years as his principal residence and then sells it, 20% of the gain would be ineligible for the exclusion and 80% of the gain would be eligible for the exclusion.

Some in the industry have stated that this safe-harbor is a gift to the taxpayer, as it provides him with specific guidance as to how he can convert his vacation home to eligible exchange property. Use of this safe-harbor will require proper planning, especially in light of the two-year period of qualified use required under the safe-harbor. It is also important to recognize that a safe-harbor is simply a specified structure, which when followed, results in IRS not challenging the transaction's eligibility. It is conceivable that a taxpayer might still do an exchange of property, outside of the safe-harbor, on property that does not meet the guidelines set out above, if facts and circumstances demonstrate that it truly has been held for investment. However, in many areas of tax, if a safe-harbor exists and is not followed, neither the IRS nor the courts have been sympathetic to the taxpayer. In attempting a non-safe harbor exchange of residential property, a taxpayer may be subject to a higher level of scrutiny by the IRS, and should seek competent tax advice from an attorney or CPA before attempting to sell or buy residential property outside of the safe-harbor.

[1] T.C. Memo. 2007-134.