

Safe harbor

Can a 1031 exchange involve a vacation home? A recent IRS bulletin spells out the safest way, but some scenarios don't fit neatly within the guidelines.

by Greg Lehrmann

The sale of an investment property can come with a pretty big tax bill if the property has appreciated significantly. Some sellers, though, can take advantage of a provision in the Internal Revenue Code to defer taxes on the gain of the sale. The provision—often referred to as a 1031 or like-kind exchange—may apply if the seller identifies and purchases a “replacement” property within the specified time frames.

Can you vacation in an investment?

Internal Revenue Code Section 1031(a) specifically provides 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 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.” Courts that have analyzed whether property is held by a taxpayer for investment have generally concluded that the requirement is met if the property is held *primarily for investment*.



In other words, limited use of the property for the taxpayer's personal enjoyment will not destroy the investment character of the property if there is objective evidence that the taxpayer's primary motive is to hold the property for investment. While it is easy to frame the issue, it is often difficult in practical terms to determine whether the taxpayer's investment intent dominates an intent to hold the property for personal use and enjoyment. This is especially true where the taxpayer owns a vacation property and uses it from time to time for personal recreation.

The practical difficulty is compounded by the fact that the IRS has provided very little guidance on how the "held for investment" requirement is met. For that reason, a recent Treasury Inspector General Audit report pertaining to the IRS's enforcement of 1031 exchanges was critical of the IRS for its failure to provide guidance to taxpayers, thereby leaving un-rebutted the claims of some promoters that vacation properties and second homes were generally eligible for exchange.

How you use the property makes all the difference

In response to the audit, the IRS has attempted to provide guidance to taxpayers concerning the exchange of vacation properties and second homes. Significantly, in February 2008 the IRS issued Revenue Procedure 2008-16, which creates a "safe harbor" under which real property held for investment and used for the taxpayer's personal enjoyment will be treated by the IRS as held primarily for investment. The safe harbor requirements are met with regard to a property relinquished in an exchange if:

- The taxpayer has owned the relinquished property for no

less than two years; and

- In each 12-month period during the two-year look-back period, the taxpayer has rented the property at fair-market rent for 14 days or more, and the taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the days the property is actually rented at fair-market rent.

While there are other technical niceties relating to how days rented and days used are counted, the foregoing ownership and use requirements comprise the main features of the safe-harbor test. Similarly, vacation-home replacement property acquired in an exchange will qualify for the safe harbor if it is retained for two years and the previously mentioned use test is met during each of those two years. In other words, this topic should be of interest whether a taxpayer is selling a vacation home or is selling, for example, a rental property and purchasing a vacation home.

Safe harbor doesn't answer all questions

While Revenue Procedure 2008-16 provides comfort for certain investors, it leaves questions unanswered for others. Clearly, the ownership and use requirements set forth in the safe harbor are narrower than the range of properties that would qualify as held by the taxpayer primarily for investment. Section 1031(a) merely requires that the taxpayer hold the property primarily for investment.

So, where is the line, as far as the IRS is concerned, between property held primarily for investment and property held primarily for personal use and enjoyment? Unfortunately, there is still no simple test to resolve that question. Some situations do not fit neatly within the safe-harbor guidelines.

Courts *have* found, though, that investment intent is lacking where there is evidence of substantial personal use of the property and the only objective evidence of investment intent is the taxpayer's hope that the property would appreciate in the future. (See *Barry E. Moore v. Commissioner*, T.C. Memo 2007-134.)

What makes a property an investment?

The IRS considers many factors to determine whether a property is held for investment. Those factors include the investor's intent, the length of time the property is held by the taxpayer, whether the property was used to generate rental income, the extent of the improvements made to the property, the extent and timing of resale activities, and whether the investor can substantiate his

To view the safe-harbor guidelines from the IRS, visit IRS.gov and type *Revenue Procedure 2008-16* into the site search.

primary motive for holding the property was for investment.

In the Moore case cited on the previous page, the tax court listed all of the things that the taxpayer did not do that an investor would do, and based on that list, concluded that the property was held primarily for personal use and enjoyment. The owners used the property every other weekend during warm weather, never attempted to rent either the property relinquished in the exchange or the property acquired in the exchange, had taken home-mortgage interest deductions instead of investment-interest deductions, and had let the property fall into disrepair when not being used by the family.

In so holding, the court commented that the mere fact that a taxpayer believes a property might appreciate in value is not sufficient to establish investment intent when the property has been used solely and extensively for personal enjoyment.

Substantiation is key

There are a number of observations regarding exchanges of vacation homes that can be drawn from the safe-harbor procedure and the Moore case.

First, an investor who has exchanged a vacation property after the March 10, 2008, effective date of Revenue Procedure 2008-16 and has complied with all of its requirements will be treated as holding both properties for investment purposes.

Next, investors performing vacation-home exchanges that do not comply with all terms of the safe-harbor guidelines due to the fact that personal use exceeds the maximum use permitted may still make the argument the property has been held for investment under the standards outlined in the Moore case.

Clearly there is a large gap between the facts in the Moore case and those required to fit within the terms of the safe-harbor provisions. It is up to each taxpayer to decide how far outside the safe harbor to go and still have a valid exchange. Whenever an investor is considering an exchange, it is essential to consult in advance with a competent tax advisor regarding the details of the contemplated transaction. ★

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