New York Law Journal
Volume 239
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Monday, June 23, 2008

VACATION HOME EXCHANGES CLARIFIED

The unanticipated implications of Rev. Proc. 2008-16 are broader.

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VACATION HOMES have long been a source of angst among exchangers and their advisors because of the lack of guidance on whether they qualify as an investment property for IRC §1031 purposes. In the past, exchangers readily exchanged 'second homes' based on the claim that in addition to enjoying the vacation home personally, they also purchased the property as an investment, and thus, it would qualify as a 1031 exchange.

Late last year, owners of vacation homes who could only show a mere scintilla of investment intent were handed a ruling that effectively ended any ambiguity in favor of structuring a sale as a 1031 exchange. Although the ruling in Moore v. Commissioner (T.C. Memo. 2007-134) made it clear that the property must be held for investment purposes, the court did not clearly define how that standard might be applied.

Accordingly, the Internal Revenue Service issued Rev. Proc. 2008-16 in March 2008 that carved out special rules for structuring the sale or purchase of a vacation home as a 1031 exchange. And while this revenue procedure does add a great deal of clarity to the issue of vacation home exchanges, there is some concern that the ruling could signal a policy shift within the Service to make the 'held for investment' requirements of an exchange more stringent.

Exchange Basics

IRC §1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment (replacement property).

Furthermore, Treas. Reg. §1.1031(a)-(1)(a)(1) provides that property held for productive use in a trade or business may be exchanged for property held for investment, and property held for investment may be exchanged for property held for productive use in a trade or business.

In order for an exchange transaction to be structured correctly, an exchanger must sell one property and purchase another with both being of 'like-kind.' Like-kind refers to the nature or character of the property, and '[t]he fact that any real estate involved is improved or unimproved is not material, for that fact relates

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only to the grade or quality of the property and not to its kind or class.' Treas. Reg. §1.1031 (a)1(b). Any property conforming to this definition will be considered like-kind.

Classifying Vacation Homes

To understand whether or not a vacation or second home could potentially be considered a 'like-kind' property, exchangers have to determine if the property was held for productive use in a trade or business or for investment purposes. Two factors that have weighed heavily on this issue are

(i) what the intent of the owners was when they purchased the property, and

(ii) whether the property was rented, or attempted to be rented, in addition to the personal use.

In the past, taxpayers most often referenced Private Letter Ruling 8103117, in which the Service ruled that a taxpayer could acquire a vacation home where the acquisition reasons were stated as being for investment purposes as well as for personal enjoyment. The PLR states that 'the house and lot you acquire in this trade will be held for the same purposes as the properties exchanged: to provide for a personal enjoyment and to make a sound real estate investment.'

The ruling took into account the fact that it is not necessary for a property to be income producing in order for it to be considered an investment property. Treas. Reg. §1.1031(a)-1(b) states, among other things, that as long as the unproductive property is not held by a dealer, not held primarily for resale, and is held for 'future use or future realization of the increment in value' it could be considered investment property.

The ruling opened the door for holding a property both for personal enjoyment and to make a sound real estate investment. A buoyant market appears to have justified many potential exchangers in believing that their vacation homes were indeed held for investment.

'Moore v. Commissioner'

In May 2007, the Tax Court, in Moore v. Commissioner, T.C. Memo. 2007-134, considered the case of a taxpayer who exchanged one vacation home for another. Neither of the homes had ever been rented and both were used solely for personal purposes. The taxpayer claimed that the properties were 'expected to appreciate in value' and, therefore, such properties were held for investment.

The Tax Court rejected this novel argument, holding that the properties were held for personal use and that the 'mere hope or expectation' that they might be sold at a gain could not establish the requisite investment intent where, as in that case, the properties were used as a residence. Citing to Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd 760 F.2d 1039 (9th Cir. 1985), the Tax Court found that vacation homes held primarily for personal use are not consistent with 'held for investment.'

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In reaching this decision the court took notice that the Moore properties were never rented, nor was there an attempt to rent them; the owners listed deductions for 'home mortgage interest' on their federal income tax returns; there was no attempt to claim any deductions for investment interest or maintenance expenses; the owners did not maintain the properties in a manner consistent with protecting their investment; and they listed a property as a 'second residence' on a refinance loan application.

Accordingly, while Moore v. Commissioner provided some clarity that vacation homes held primarily for personal use do not qualify for exchange treatment, it did not give specific guidance on how much personal use is allowed while still qualifying as an 'investment' property for exchange purposes.

Subsequent Treasury Report

Subsequent to the Moore ruling, the Treasury Department issued a report on its evaluation of the Internal Revenue Service's oversight of the deferment of capital gains tax through like-kind exchanges.

The report, issued in September 2007, included recommendations on clarifying tax reporting requirements, as well as further study of compliance issues by the IRS. Additionally, beyond the general scope of the report, the Treasury Department singled out perceived abuses with regards to vacation home and residential property exchanges.

The report stated that a vacation home used exclusively by the owner or related parties may not be exchanged. It further noted there was a lack of guidance in situations where the home was not used exclusively by such persons, or where there is some rental history or attempts to rent.

The Treasury Department believed that the lack of guidance left 'unrebutted the sales pitch of like-kind exchange promoters' who may encourage taxpayers to exchange non-qualifying vacation homes. The Treasury Department tasked the IRS with providing additional guidance regarding exchanges of second and vacation homes that were not used exclusively by the owners, as well as caution to taxpayers on uninformed or improper promoting techniques in the industry.

Rev. Proc. 2008-16

In response to the Treasury Department's recommendations, the Service issued Rev. Proc. 2008-16 in March 2008. While most of it appears to be influenced by the Moore ruling there have been some changes.

Section 3.02 of the Rev. Proc. first limits the scope of the ruling as only pertaining to 'dwelling units,' which are defined as 'real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.'

The Rev. Proc. thereafter defines the 'qualifying use standards' of a relinquished

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property dwelling unit as follows:

a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (defined as the 'qualifying use period'); and

b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) the period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rental at a fair rental.

The rules for the purchase of a replacement property mimic the rules for a relinquished property, except that the qualifying activities are prospective.

Despite the Service's strong position against the 1031 eligibility of personal residences, they acknowledged that such 'mixed use' property can constitute, within the meaning of §1031(a), property held for productive use in a trade or business or for investment. The Rev. Proc. provides a 'safe harbor' under which the IRS will not challenge the assertion that a dwelling unit qualifies as 'property held' (for productive use in a trade or business or for investment) for purposes of §1031(a). An exchange may still fall outside the parameters and meet the statutory requirements, but the taxpayer should expect heightened scrutiny in such a case.

The guidelines are applicable with respect to exchanges of dwelling units that occur on or after March 10, 2008. Rev. Proc. 2008-16 'expresses no opinion' on the status of exchanges -- even those that meet the guidelines set forth in it -- that take place before that date. (It seems unlikely, as a practical matter, that the Service will seek to challenge exchanges that take place before the effective date if the exchange meets the standards set forth in that document.)

Further, Rev. Proc. 2008-16 makes it clear that if, with respect to the replacement property, the taxpayer does not meet the 'ownership and use' requirements imposed by Rev. Proc. 2008-16, the taxpayer will be expected to file an amended tax return to remain within the safe harbor, for the taxable year in which the exchange was completed, and report, on such return, the gain derived from the exchange.

What Is a 'Dwelling Unit'

In many situations, the Service views the absence of guidance as a more effective deterrent to abuse than publication of guidance. The Treasury Department felt it necessary to clarify the requirements and deter the perceived abuses of the system. The Rev. Proc. does appear to clarify the situation on the qualification of second homes, but also opens a Pandora's box on many other key 1031 principles.

The Rev. Proc. specifies that it is only applicable to dwelling units, but leaves

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unanswered questions such as whether there is a differentiation between a rental property, second home and vacation home. Although the Treasury Department report did cite concerns about taxpayer abuse related to IRC §121 exemptions, the report's recommendation was to provide 'additional guidance to taxpayers regarding the rules and regulations governing like-kind exchanges with respect to second and vacation homes that were not used exclusively by owners.'

The Rev. Proc., as issued, appears to be much broader than anticipated.

Both rental properties and second homes will likely fall under the classification of a 'dwelling unit.' However, there are important distinctions that can be made between them: A second home has a potential intent of some personal use, while a rental property will likely have no intended personal use, with the primary intention of rental purposes.

From an industry standpoint, a true rental property was perceived to qualify as an investment property, regardless of whether the taxpayer was able to find a tenant, given that the owners' true intent is the income or appreciation opportunity of the property with no intentions of personal use. Under Rev. Proc. 2008-16, there is a requirement for safe harbor purposes that the property is actually rented regardless of the taxpayer's true intent.

This appears to create a quandary for those taxpayers who have a true investment intent pertaining to the ownership of the property, but for reasons such as the deflated economy have been unable to rent it. The Rev. Proc. undermines the fundamental principle of 'investment intent' while also potentially contradicting Treas. Reg. 1.1031(a)-1(b) which states that 'unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment.' The Rev. Proc. removes the concept of intent and replaces it with actual rental time, which is a material shift in philosophy.

Length of Holding Period

Although the Rev. Proc. is a safe harbor for dwelling units and thereby limited in scope and application, it stands to have a much more profound effect on the industry.

As previously mentioned, many times the Service views the absence of guidance as a more effective deterrent to abuse than publication of guidance. Taxpayers and their advisors will typically look to the Code, as well as revenue procedures, Tax Court decisions and private letter rulings as a gauge of the administration's position on varying issues that may not be clearly defined in §1031. Therefore, the release of a safe harbor ruling on second homes is likely to have a profound impact on the much broader 1031 industry to the extent it touches upon universal requirements and concepts.

One such area could be the applicable holding period specified in Rev. Proc. 2008-16. It requires a 24-month hold period on both the relinquished and replacement properties. There is a general view in the industry that a one-year hold period should be sufficient to show an investment intent. Although the authors are not against the Service clarifying a specified hold period, we are not sure that the

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intent, nor the considerations, in preparation of the Rev. Proc. were to establish a time period to qualify for 1031.

Although the procedure is limited in application, the taxpayer will likely have to 'read between the lines' as to the intent of the Service in specifying such a time requirement. To say that this has no impact is not fair, given that such a universal time parameter for qualifying as an investment property should not really differ from one property type to another.

How should one view the exchange of a property under two years given the safe harbor requirements of 2008-16? Was this an intended action, or inadvertently incorporated into the fold?

Amended Tax Returns

Lastly, further evidence of a shift in philosophy is the subtle, yet powerful statement included in Rev. Proc. 2008-16 §4.05, 'Special rule for replacement property.'

The section suggests that a taxpayer purchasing a replacement property expecting to meet the qualifications, but who in actuality does not, 'if necessary, should file an amended return and not report the transaction as an exchange.' Once again, this is a dramatic shift from the concept of investment intent.

The Rev. Proc. is stating that taxpayers with true intentions to meet the qualifications, but who for one reason or another shift their usage of the property, or potentially are forced to sell it within a 24-month period, should amend their tax returns and recognize the gain on the original sale of the relinquished property.

Although trying to protect against abuses of the system, this self-disqualification requirement may place an unfair burden on taxpayers who truly set out with the intention of adhering to the qualification of an investment property, but over time change their utilization of the property due to unforeseen circumstances.

Conclusion

In many instances where there is a lack of guidance by the Service, taxpayers are in a position of being unclear as to whether their transactions would qualify for the benefits of §1031.

In that regard, the industry applauds the issuance of guidance to clarify such situations. However, Rev. Proc. 2008-16 appears to open up many additional issues in its attempt to merely clarify exchanges of vacation homes, which may have unintended consequences.

The guidance will likely give rise to many other situations, which may or may not fall under the scope of Rev. Proc. 2008-16, whereby taxpayers are left in a very difficult position of assessing the qualifications of their property. There are

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many foreseeable situations whereby taxpayers with true qualifying intent may be inclined to pass upon the benefits afforded to them through §1031 because of the ambiguities of Rev. Proc. 2008-16.

Although such unfair burdens were likely not intended by the Rev. Proc., the attempts to clarify one issue will have a much broader impact than the initial undertaking, and likely create many other unclear situations.

Those taxpayers considering the sale and exchange of a dwelling unit of any type will definitely want to consider the implications of the Rev. Proc. and plan accordingly. It appears that while certain questions have been answered, there will need to be further clarification for numerous circumstances.

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6/23/2008 NYLJ 9, (col. 5)

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