



Agricultural Law Press

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Guidance from IRS on Eligibility of Vacation Properties for Like-Kind Exchange Treatment

-by Neil E. Harl*

The long-awaited guidance on whether vacation properties which are rented out but are also occupied by the owner for personal use are eligible for like-kind exchange treatment¹ was released on February 14, 2008.² The guidance, in the form of a safe harbor, provides useful guidance in an area that has posed troubling questions for taxpayers (and tax practitioners) for years.

Basic authority

It has been clear for decades that non-recognition of gain has been the result under the like-kind exchange rules³ if an exchange of property occurs, the property relinquished and the property acquired are like-kind, both properties are held for productive use in a trade or business *or for investment* and, if the properties are not exchanged simultaneously, the timing requirements for identification of the replacement property and receipt of the replacement property are satisfied.⁴ The regulations have taken the position for some time that property held for productive use in a trade or business may be exchanged for property held for investment.⁵ Likewise, the regulations state that property held for investment may be exchanged for property held for productive use in a trade or business.⁶

It has also been well established that gain or loss from an exchange of personal residences cannot be deferred under the like-kind exchange rules because the residences are not property held for productive use in a trade or business or for investment.⁷ Authority published in 2005 confirmed that like-exchange rules did not apply to property used solely as a personal residence⁸ as did the well-known case, *Starker v. United States*.⁹

It has not been clear whether properties (such as vacation homes) which are rented out for part of the year, indicating the property has been held for investment, are eligible for like-kind exchange treatment if the property is also used by the owner or owners for personal purposes during the year. A 2007 Tax Court case¹⁰ held that an exchange of vacation homes used only for personal purposes (neither was ever rented) was not eligible for like-kind exchange treatment. The taxpayers argued that the properties were expected to increase in value over time and, therefore, were held for investment. The Tax Court held that the properties were held for personal use and holding the properties for appreciation was not sufficient to qualify the vacation homes as investment property.¹¹

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The safe harbor

Under the safe harbor, a “dwelling unit”¹² which the taxpayer intends to be relinquished property in a like-kind exchange¹³ qualifies as property held for productive use in a trade or business or for investment if – (1) the dwelling unit has been owned by the taxpayer for at least 24 months immediately prior to the exchange and (2) in each of the 12-month periods immediately preceding the exchange the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more and 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 rented at a fair rental.¹⁴

Likewise, property the taxpayer intends to be *replacement* property qualifies if – (1) the dwelling unit is owned by the taxpayer for at least 24 months immediately *after* the exchange and (2) within that “qualifying use” period, in each of the two 12-month periods immediately after the exchange, the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more and 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 rented at a fair rental.

“Personal use” occurs on any day the taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2), taking into account § 280A(d)(3) (pertaining to rental to a family member as the principal residence) but not § 280A(d)(4) (relative to rental of a principal residence).¹⁵ The term “fair rental value” is a facts and circumstances matter, based on the facts and circumstances existing when the rental agreement is entered into.¹⁶

The guidance points out that if the taxpayer files a federal income tax return and reports a transaction as an exchange under § 1031 and later finds that the requirements have not been met, the taxpayer is to file an amended return.¹⁷

The safe harbor provisions are effective for exchanges occurring on or after March 10, 2008.¹⁸

In conclusion

As with any safe harbor, this authority does not preclude a transaction outside the scope of the authority from qualifying but it does provide assurance that a transaction within the scope of the guidance will not be challenged.

FOOTNOTES

¹ I.R.C. § 1031. See generally 4 Harl, *Agricultural Law* § 27.04 (2008); Harl, *Agricultural Law Manual* § 4.02 (2008); 1 Harl, *Farm Income Tax Manual* § 2.07 (2007 ed.); Harl, “Like-Kind Exchanges: A Popular Option for Property Transfers,” 11 Drake J. of Agric. L. 25 (2006). See also Harl, “Can Trust Beneficiaries Use Section 1031 Exchanges?” 18 *Agric. L. Dig.* 97 (2007); Harl, “No ‘Basis Shifting’ in Related Party Like-Kind Exchange,” 18 *Agric. L. Dig.* 33 (2007); Harl, “What Is

‘Like-Kind’ for Real Estate?” 17 *Agric. L. Dig.* 177 (2006).

² Rev. Proc. 2008-16, I.R.B. 2008-10.

³ I.R.C. § 1031(a)(1).

⁴ I.R.C. § 1031(a)(3).

⁵ Treas. Reg. § 1.1031(a)-1(a)(1).

⁶ *Id.*

⁷ Rev. Rul. 59-229, 1959-2 C.B. 180.

⁸ Rev. Proc. 2005-14, 2005-1 C.B. 528, § 2.05.

⁹ 602 F.2d 1341, 1350 (9th Cir. 1979).

¹⁰ Moore v. Comm’r, T.C. Memo. 2007-134.

¹¹ *Id.*

¹² Dwelling unit is 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.” Rev. Proc. 2008-16, I.R.B. 2008-10, § 3.02.

¹³ I.R.C. § 1031.

¹⁴ Rev. Proc. 2008-16, I.R.B. 2008-10, § 4.02(1).

¹⁵ Rev. Proc. 2008-16, I.R.B. 2008-10, § 4.03.

¹⁶ *Id.*, § 4.04.

¹⁷ *Id.*, § 4.05.

¹⁸ Rev. Proc. 2008-16, I.R.B.2008-10.

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