Like-Kind Exchanges of Vacation Properties Require Caution

Despite a recently issued safe harbor now available for like-kind exchanges of vacation properties, the Internal Revenue Service continues to keep taxpayers guessing on the precise boundaries of the law itself.

Last September, the Government Accountability Office came out with a critical report on like-kind exchanges in which it complained that the IRS needed to give taxpayers more guidance on like-kind exchanges of second homes and vacation retreats. The GAO claimed that the IRS has agreed with its findings and had promised to release more specific guidance. The latest IRS response seems to fall short of that commitment.

The IRS's response, in the form of Rev. Proc. 2008-16, contains an extremely rigorous, Internal Revenue Code of 1986, as amended ("Code") Sec.280A-based safe harbor rule that will continue to keep taxpayers wondering what limits have actually been set.

The rationale underlying the like-kind exchanges provisions is that there should be no recognition of gain when the new property is essentially a continuation of the old investment or business asset, which is still unliquidated.

- **Requisite intent.** The determination of whether property is held for productive use in a trade or business of for investment is made at the time of the exchange. The taxpayer has the burden of proving that the property is held for such uses. If the property transferred was originally acquired for non-qualifying purposes, but was held for qualifying purposes at the time of the exchange, the requirement is technically satisfied.

A similar rule applies to the property received. If the intention at the time of receipt was to hold the property for productive use in a trade or business or for investment, and there is a later change in purpose (e.g., converting the property to personal use) or disposition of the property, the transaction may still qualify for non-recognition treatment.

The nub of the problem for vacation-type properties is determining how the property is held at the time of the exchange, as well as both immediately before and immediately after. Even there, however, the waters are murky. Is intent measured by the purpose for which the property was used at the time of the exchange (that is, for rental or personal use) or does an intention to continue to use the property occasionally for personal use (should the exchange not go through taint the property as purely held for investment for like-kind exchange purposes?

Gain or loss from an exchange of a personal residence generally does not qualify for non-recognition under Code Sec. 1031, because a residence is not property held for productive use in a trade or business of for investment. However, when the taxpayer rents out a dwelling unit, such as a vacation property, holding it primarily for the production of current rental income, but also occasionally uses it for personal purposes, the taxpayer may be able to qualify for non-recognition under Code Sec. 1031.

For exchanges of dwelling units occurring on or after March 10, 2008, Rev. Proc.2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as "property held for productive use in a trade or business or for investment" for like-kind exchange treatment under Code Section 1031, even though the taxpayer occasionally uses the dwelling unit for personal purposes.

The safe harbor provides that the relinquished and replacement property qualifies as property held for productive use in a trade or business of for investment if each of the dwelling units is owned by the taxpayer (one for at least 24 months immediately before the exchange, and the other for at least 24 months immediately following the exchange), and within that time, in each of the two 12 month periods:

- The taxpayer rents the dwelling unit to another person or persons at a fair rental price 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 price.

If the limits set forth in Rev. Proc. 2008-16 look familiar, the reason is that they mirror limits imposed under Code Section 280A for losses allowable on vacation property. Deductible losses are limited to rental income if there is "significant personal use" that is measured as use for personal reasons for more than the greater of 14 days or 10 percent of the total days rented. Under a companion de minimis rule, if the property used as a residence by the owner is also rented out for fewer than 15 days during the year, rental income is not included, and expenses attributable to the rental property are ignored.

A note of caution: While the 14-day-or-10-percent rule for the like-kind safe harbor mirrors Code Section 280A's test for a "residence" for rental expense deduction and rental income recognition purposes, the Code Section 280A test looks at each taxable year, while the new Code Section 1031 safe harbor tests each 12-month period immediately prior to and after the exchange.

And a note of surprise: The IRS cited only one judicial decision to support its new revenue procedure, Moore, T.C. Memo. 2007-134, CCH, Dec. 56,950(M). The taxpayers there claimed that the exchange of vacation homes was a like-kind exchange because the properties were held for investment simply due to the expectation of price appreciation. Turning that win into justification for two-year holding and use periods both before and after the exchange seems itself confusing. The IRS did not explain further.

One further caution for vacation property held in Mexico, Canada or elsewhere. Real property located in the United States and real property located outside the United States are not like-kind properties.

The American Jobs Creation Act of 2004 amended Code Sec. 121 to deny the homesale exclusion to property that is acquired in a like-kind exchange, converted to a personal residence, and disposed of within five years after the like-kind exchange. This five-year rule works independently of the two-year safe harbor. Congress was concerned that the homeowner exclusion could be used to shelter the gain residence was sold shortly after the like-kind exchange occurred.

Looking at Rev. Proc. 2008-16 from another angle, however, the IRS's safe harbor may have been exceedingly generous. If property can be considered mixed use at the time of the exchange, the IRS may be saying that a certain amount of personal use will not only not prevent like-kind treatment, but also will not require allocation of a portion of the gain to personal use (that is, for example, allocation of the 14 out of 365 days of personal use).

In Rev. Proc 2005-14, the IRS held that a taxpayer may qualify for both Code Section 121 gain exclusion on the exchange of a principal residence and Code Section 1031 non-recognition of gain from a like-kind exchange if the taxpayer used the property as a principal residence for the required period but, at the time of the exchange, the property was investment property.

It also examined what happens when the taxpayer uses part of the property as a residence and part of the property for the conduct of a trade or business. In both instances, the IRS allowed the Section 121 gain exclusion to be applied before application of the Section 1031 non-recognition rules. How deeply that ruling should be read to determine the permissible holding period for investment property remains a question, especially in light of the IRS's latest safe harbor.

CONCLUSION

The GAO in its report had remarked that, while "the absence of guidance may be a more effective deterrent to abuse than publication of guidance, in this case, unscrupulous or uniformed promoters are already taking advantage of the IRS's silence." I would add that honest taxpayers, are confused over what the tax law allows them in the absence of further guidance from the IRS.

Rev. Proc. 2008-16 reaches back two years in both directions to test objective evidence of intent. While almost a "no brainer" as far as its conclusion, it at least provides certainty now for those that fit within the safe harbor that the IRS isn't going to give them audit trouble.

To those who don't fit both sides of the two-year rule, however, the IRS may be sending out the disturbing message that it will challenge everything else.

Or, as the GAO suggested, perhaps the IRS just want to keep everyone guessing.