

1031 Exchanges of Residential Property: IRS Issues New Safe-Harbor Guidelines

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Rev Proc 2008-16, 2008-10 IRB

A new IRS Revenue Procedure 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 under Code Sec. 1031. Rev. Proc. 2008-16 sets rental standards, establishes a qualifying use period and concludes that limited personal use will not prevent a dwelling unit from qualifying under the holding purpose test of the tax-free exchange rules. This Revenue Procedure comes on the heels of *Moore v. Commissioner*, T.C. Memo. 2007-134 (the recent vacation home case).

Personal residences cannot be exchanged tax-free under Code Sec. 1031 because they are not held for productive use in a trade or business or for investment. The question challenging taxpayers has been "How much rental is needed to meet the holding purpose test?" Rev. Proc. 2008-16 squarely answers this and also provides indirect guidance on the issue of converting a principal residence into qualifying relinquished property prior to an exchange, or converting replacement property into a personal residence after an exchange.

New safe harbor, but just a safe harbor. IRS now provides taxpayers with a safe harbor under which a dwelling unit (real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities) will qualify as property held for productive use in a trade or business or for investment for Code Sec. 1031 purposes even though it is occasionally used for personal purposes. The safe harbor is effective for exchanges occurring on or after March 10, 2008. No inference is intended with respect to the federal tax treatment of such exchanges taking place before March 10, 2008.

IRS will not challenge whether a dwelling unit satisfies the holding purpose test under Code Sec. 1031 if:

- the taxpayer owns both properties for the qualifying use period (for the relinquished property, at least 24 months immediately before the exchange; for the replacement property, at least 24 months immediately after the exchange); and
- within the qualifying use period, in each of the two 12-month periods immediately preceding and following the exchange, (i) the taxpayer rents the dwelling unit to another person(s) at a fair rental for 14 days or more, and (ii) the period of the taxpayer's personal use of the dwelling unit doesn't 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.

IRS pointed out that the new safe harbor applies only to the determination of whether a dwelling unit is held for productive use in a trade or business or for investment under Code Sec. 1031, and that a taxpayer using the safe harbor also must satisfy all other requirements for a like-kind exchange under Code Sec. 1031 and the Regulations. An exchange may still fall outside the safe harbor parameters and meet the statutory requirements, but increased scrutiny may be triggered. We do not yet know if Rev. Proc. 2008-16 will result in changes to the exchange reporting Form 8824.

Broad definition of personal use. The taxpayer is deemed to have used a dwelling unit for personal purposes on any day the dwelling unit is used by: (A) the taxpayer or any other person who has an interest in such unit (including a tenant in common), or by any member of the family of the taxpayer or such other person; (B) by any individual who uses the unit under a reciprocal arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or (C) by any individual if rented for less than a fair market value rental. A taxpayer may rent the dwelling unit to a family member if the family member uses it as a principal residence (and not a vacation home) and the family member pays fair market rent. Some taxpayer usage may be allowed for repairs and annual maintenance as well. See Code Sec. 280A(d)(2) and (3).

Failing personal use test for replacement property. A taxpayer may file a federal income tax return and report a swap of dwelling units as a tax-free exchange, based upon meeting the qualifying use standard for the relinquished property and the expectation that he will meet the qualifying use standard for the replacement property, but ultimately he may fail to meet the latter standard. If necessary, in this situation the taxpayer should file an amended return and not report the transaction as an exchange under Code Sec. 1031.

Conclusion. To meet this safe harbor, the taxpayer must address the new qualifying use periods both 24 months before the exchange for the relinquished property, and 24 months after the exchange for the replacement property. In each of these four 12- month periods, personal use as defined above must be severely limited, and the property must be rented to a qualifying user for at least 14 days. Overall, taxpayers should be pleased to have such a liberal standard to qualify residential property for Code Sec. 1031 tax deferral.