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## **New ruling has been issued: Safe harbor for vacation homes with 1031 exchanges**

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Until recently, there has been little guidance from the IRS as to whether or not vacation homes qualify for §1031 exchanges. In 2007, the Tax Court issued a ruling, in *Moore v. Commissioner*, that provided the most comprehensive discussion of vacation homes to date. In that case, the taxpayer exchanged one lake house for another, both of which had been used for personal use as a second home. However, the taxpayer argued that the primary purpose of holding both houses was for investment. The tax court found that the primary use of the property should control the "held for investment" test, and that in this case the primary use was personal. The property did not qualify for §1031 treatment. The court considered the following factors in making their determination:

- \*The primary use of the property was personal;
- \*The taxpayer never attempted to rent the house;
- \*The taxpayer did not keep the house well-maintained;
- \*The taxpayer did not deduct maintenance expenses or depreciation as business expenses on its tax returns;
- \*The taxpayer, instead, took a 2nd home mortgage deduction on tax returns;
- \*The mere hope of appreciation does not show investment intent.

This case provided some limited guidance. However, effective March 10, the IRS issued Revenue Procedure 2008-16, which sets forth a safe-harbor, under which the qualification of a residential property for 1031 exchange treatment will not be challenged by the IRS. A dwelling unit will now qualify as exchange property if the following standards are met:

- \*The relinquished property has been owned by the taxpayer for at least 2 years preceding the exchange; and
- \*Within those 2 years, the taxpayer has rented the property at fair market value for at least 14 days each year; and
- \*The taxpayer's personal use has not exceeded the greater of 14 days or 10% of the number of days rented each year.

The same rules apply to the replacement property for at least 2 years following a like-kind exchange. Taxpayers should note that this safe harbor broadly defines "personal use". Use by a co-owner, or use by any person for less than fair market rental value or in exchange for personal use of another unit, is deemed to be personal use of the taxpayer. A taxpayer may rent the unit to a family member as long as fair market value rent is paid. The taxpayer is also allowed to use the unit while making repairs or doing maintenance to the unit, without being counted as personal use, but he must be able to prove that he actually did work on the unit.

The "vacation home safe harbor" actually applies to the conversion of any residential property from

personal use to eligible exchange use. This presents an excellent planning opportunity for those who currently own personal use property and want to convert it to eligible exchange property. All a taxpayer would need to do is continue to own the property for at least two years prior to the sale, rent it out at fair market value for 14 days each year, limit their own personal use of the property to 14 days a year or 10% of the rental period, and then sell it in an exchange. A taxpayer can also exchange out of business or investment property and acquire replacement property he intends to use for personal use in the future, as long as he follows the safe harbor rules for the first two years following the exchange.

This safe-harbor may be a great gift to the taxpayer, as it provides specific guidance for converting vacation homes to eligible exchange property and vice versa. However, use of this safe-harbor will require proper planning, especially in light of the two-year period of qualified use required under the safe-harbor. Taxpayers should consult with their attorney or CPA to make sure they follow the rules to get the advantage they seek in a Â§1031 exchange!

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