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How to do a Section 1031 exchange on a vacation home held for investment

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Internal Revenue Code Sec. 1031(a) provides that "no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Courts that have analyzed whether property is held by a taxpayer for investment have generally concluded that the requirement is met if the property is held "primarily for investment." In other words, limited use of the property for the taxpayer's personal use and enjoyment will not destroy the investment character of the property if there is objective evidence that the taxpayer's primary motive is to hold the property for investment. While it's easy to frame the issue, it is often difficult in practical terms to determine whether the taxpayer's investment intent dominates an intent to hold for personal use and enjoyment especially where the taxpayer holds a vacation property and uses it from time to time for personal enjoyment. The practical difficulty was compounded by the fact that the IRS has provided very little guidance on how the held for investment requirement is met. For that reason, a recent treasury inspector general Audit report (TIGA) pertaining to the IRS's enforcement of 1031 exchanges was critical of the IRS for its failure to provide guidance to taxpayers thereby leaving unrebutted the claims of some promoters that vacation properties and second homes were generally eligible for exchange.

In response to the TIGA audit, IRS has attempted to provide guidance to taxpayers concerning the exchange of vacation properties and second homes. Significantly, in Feb. the IRS issued Revenue Procedure 2008-16 which creates a "safe harbor" under which real property held for investment which is also used for the taxpayer's personal enjoyment will be treated by IRS as held primarily for investment. The safe harbor requirements are met with regard to a property relinquished in an exchange if: (1) the taxpayer has owned the relinquished property for no less than 2 years, and (2) in each 12 month period during the two year look back period, the taxpayer has rented the property at fair market rent for 14 days or more, and the taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the days the property is actually rented at fair market rent. While there are other technical niceties in Rev. Proc. 2008-16 relating to how days rented and days used are counted, the foregoing ownership and use requirements comprise the main features of the safe harbor test. Similarly, replacement property acquired in an exchange will qualify for the safe harbor if it is retained for two years and the previously mentioned use test is met during each of those 2 years.

While Revenue Procedure 2008-16 will provide comfort for certain investors, it leaves many questions unanswered. Clearly, the ownership and use requirements set forth in the safe harbor are narrower than the range of properties that would qualify as held by the taxpayer primarily for investment. Section 1031(a) merely requires that the taxpayer hold the property primarily for

investment. So, where is the line between property that will be considered as held primarily for investment and property that will be considered held primarily for personal use and enjoyment? Unfortunately, there is still no simple test to resolve that question. Courts have found that investment intent is lacking where there is evidence of substantial personal use of the property and the only objective evidence of investment intent is the taxpayer's hope that the property would appreciate in the future.

The IRS considers many factors to determine whether a property is held for investment. Among other factors, they include the investor's intent, the length time the property is held by the taxpayer, whether the property was used to generate rental income, the extent of the improvements made to the property, the extent and timing of resale activities and whether the investor can substantiate their primary motive for holding the property was for investment. In the Moore case, the tax court listed all of the things that the taxpayer did not do that an investor would do to conclude that the property was held primarily for personal use and enjoyment. The taxpayer never attempted to rent the property relinquished in the exchange or the property acquired in the exchange, had taken home mortgage interest deductions instead of investment interest deductions and had let the property fall into disrepair when the property was not being used by the family. In so holding the court commented that the mere fact a taxpayer believes a property might appreciate in value is not sufficient to establish investment intent when the property has been used solely for the personal enjoyment.

There are a number of observations regarding exchanges of vacation homes that can be drawn from the safe harbor procedure and the Moore case. First, an investor who exchanges a vacation property after the effective date of the Rev. Proc. and complies with all of its requirements will be treated as holding both properties for investment purposes. Next, investors performing vacation home exchanges who do not comply with all terms of the Revenue Procedure due to the fact that their personal use exceeds the maximum use permitted may still make the argument the property has been held for investment under the standards outlined in Moore. Although the Revenue Procedure created a safe harbor for certain transactions, it did not alter the ability of an investor to substantiate that vacation property has been held primarily for investment notwithstanding non-compliance with the Revenue Procedure. Clearly there is a large gap between the facts in Moore and those required to fit within the terms of the Rev. Proc. Finally, and more importantly, whenever an investor is considering an exchange, it is essential to consult in advance with a competent tax advisor regarding the details of the contemplated transaction.

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