Section 1031 Exchanges of Vacation Homes

By Karen Mendelson

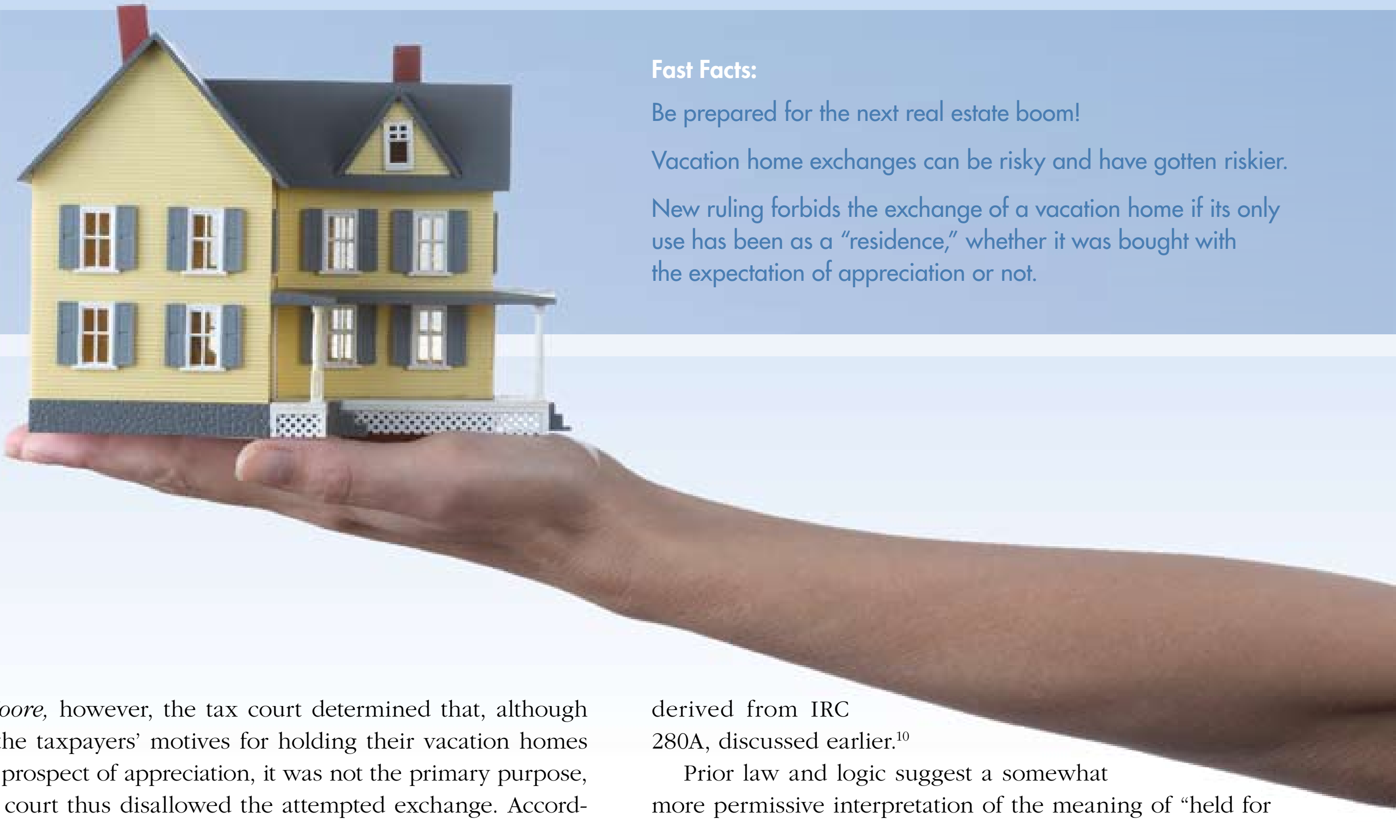
As a general rule, gain or loss on the sale or exchange of property is recognized—i.e., taxed—unless an exception is found in the Internal Revenue Code (IRC).[1] IRC 1031(a) is such an exception. It provides that "[n]o gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for" like property.[2]

Vacation home buyers often rationalize their purchases with an explanation like, No one is creating any more lakefront property, so it's bound to appreciate. Those buyers would argue that their vacation homes are held as investments, not personal residences, so they ought to be able to exchange them under § 1031 without being taxed. Analogizing to IRC 280A (which defines when a dwelling is a "residence" for the purpose of determining permissible expense deductions)[3] and citing *Starker v United States,*[4] many conservative practitioners have assumed that a vacation home is a personal residence if the owner uses it more than 14 days a year and that the owner therefore cannot benefit from the tax-deferral provisions of § 1031. Other, more aggressive counsel have advised their clients that vacation home exchanges are permissible under much broader circumstances. Despite how frequently this issue has arisen, however, there had been very little guidance up until now on when gain from the exchange of a vacation home may be deferred under § 1031.

Two recent developments have shed light on the positions of the Internal Revenue Service and the United States Tax Court. First, a tax court panel addressed § 1031 exchanges of vacation homes in *Moore v Internal Revenue Comm'r.*[5] Second, the IRS promulgated Revenue Procedure 2008-16,[6] which provides a safe harbor for some vacation home exchanges. Both *Moore* and Rev Proc 2008-16 take the position that whether a property is "held for investment" (and, therefore, exchangeable under § 1031) should be determined by considering the same criteria used to determine whether property is held "for production of income" or "for profit" under other sections of the tax code, e.g., IRC 212 (expenses for the production of income), IRC 162 (trade or business expenses), IRC 165 (business losses), IRC 167 (depreciation), and IRC 183 (activities not engaged in for profit).

The United States Court of Appeals for the Sixth Circuit discussed those criteria at length in *Holmes v Internal Revenue Comm'r.*[7] In *Holmes,* the Sixth Circuit followed a nine-factor test promulgated in a treasury regulation under IRC 183, 26 CFR 1.183-a(2), for determining whether taxpayers have a sufficient profit motive to support allowing a deduction for a loss. The factors include the following: Does the taxpayer carry out the activity in a businesslike manner, has the taxpayer acquired expertise in the area, does the taxpayer devote significant time and effort to the activity, does the taxpayer expect the property to appreciate, has the taxpayer succeeded in other profit-making activities, and is there a recreational or personal element involved in carrying out the activity? In *Holmes,* the Sixth Circuit agreed with the taxpayers that their "arboreal, horticultural, and piscine labors and investments" met the profit-motive test, even though such activities did not provide the taxpayers' primary source of income and were undertaken on the property where they lived.[8] The court thus permitted the expensing of costs incurred and deduction of losses in connection with those activities.

The closer one gets to limiting personal use, the more likely the exchange will be considered valid. It still depends on the facts.



Fast Facts:

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Vacation home exchanges can be risky and have gotten riskier.

New ruling forbids the exchange of a vacation home if its only use has been as a "residence," whether it was bought with the expectation of appreciation or not.

In *Moore,* however, the tax court determined that, although one of the taxpayers' motives for holding their vacation homes was the prospect of appreciation, it was not the primary purpose, and the court thus disallowed the attempted exchange. According to *Moore,* the "mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."[9] Taking note that the taxpayers had never attempted to lease the properties, did not offer them for sale until they needed cash because of their divorce, had made improvements to the properties for which they received the benefit, had taken home mortgage interest deductions for the properties, and had not taken any deductions for maintenance expenses or depreciation, the *Moore* court decided that neither the original nor replacement home was being held for the production of income; rather, they were personal residences.

Rev Proc 2008-16 adopted the same stance as *Moore,* affirming that the IRS will not challenge an exchange of vacation homes under the following, limited circumstances:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and,

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

   (i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

   (ii) 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.

Similar requirements apply for the two-year period following acquisition of the replacement property. These time frames were derived from IRC 280A, discussed earlier.[10]

Prior law and logic suggest a somewhat more permissive interpretation of the meaning of "held for investment" under § 1031 than *Moore* and Rev Proc 2008-16 would allow. Consider, for example, a 1980 private letter ruling[11] involving a taxpayer who owned a vacation home and an unimproved lot in the same community. The home was intermittently rented or used for the taxpayer's personal benefit, although it had not been rented for the six or seven years before the ruling, during which time the taxpayer occupied it approximately 10 days a year for maintenance purposes. According to the private letter ruling, the taxpayer's purposes for holding the properties were "to provide for personal enjoyment of the community and also to make a sound real estate investment." The taxpayer wanted to exchange that home and lot under § 1031 for another home and lot to be held for the same purposes in the same community. The IRS advised that the transaction satisfied § 1031, as the properties were "held for investment."

Serdar v Internal Revenue Comm'r,[12] an installment-sale case, addressed a couple's "investment purpose" under § 1031 in dicta in a footnote:

> The fact that petitioners intended to allow their son and his family to reside at Engelhart Farm does not, as respondent suggests, settle the issue of whether petitioners intended to hold Engelhart Farm for investment purposes. A taxpayer's intent to hold property for investment must be determined as of the time of the exchange. *Click v. Commissioner,* 78 T.C. 225, 231 (1982). For purposes of sec. 1031, property is held for investment purposes if losses from the sale or exchange of such property are deductible. *Starker v. United States,* 602 F.2d 1341, 1350–1351 (9th Cir. 1979). When property is purchased both to provide a residence

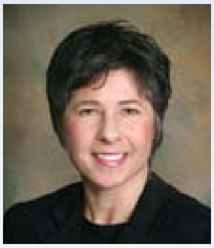
> for relatives, and for investment purposes, a loss from the sale or exchange of the property is deductible if it is held primarily for investment purposes. *Jefferson v. Commissioner,* 50 T.C. 963, 968 (1968). Whether property is held primarily for investment purposes is a question of fact. *Jefferson v. Commissioner, supra.*[13]

Although the *Serdar* petitioners used the residence for their (or their relative's) personal use, the court nonetheless appeared to believe that they would have been able to establish a sufficient profit motive to qualify for a § 1031 exchange.

Jefferson v Internal Revenue Comm'r,[14] a case decided under IRC 165 (which concerns business losses), also contains a broader view of what constitutes profit motive than *Moore.* In *Jefferson,* the parties stipulated that both "personal concern for his mother's welfare and…a business concern to 'turn a profit on (the) deal'" had motivated the taxpayer to purchase his mother's home.[15] The court allowed a deduction for the loss on the sale of the home even though the taxpayer had purchased the home from his mother and his mother lived there full-time for free. The taxpayer's prior successful dabbling in real estate, plus his (thwarted) expectation of profit, seemed to convince the court that the transaction had been conducted primarily for profit. The court also found it significant that, although the taxpayer's mother did not drive, the taxpayer had made improvements to the garage and driveway while she lived there.

Finally, even if a dwelling is considered a residence under IRC 280A, a taxpayer is not entirely precluded from taking deductions for expenses if the dwelling is also rented out. The IRS uses an apportionment formula.[16] At a minimum, there is no reason why the same type of apportionment should not be made in the § 1031 context.

To conclude, there is no bright-line test for when a vacation home may be exchanged under § 1031 beyond the limited circumstances described in the 2008 revenue procedure. A person who expects appreciation of his or her vacation home, does not occupy it more than 14 days a year, and rents it out is safe. On the other hand, an owner's part-time occupancy of a vacation home, failure to rent it out, or mixed motives in holding it need not be viewed as an automatic disqualification from § 1031 treatment. The closer one gets to limiting personal use, the more likely the exchange will be considered valid. It still depends on the facts. ■



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FOOTNOTES

1. 26 USC 1001(c); IRC 1001(c). The IRC is codified in title 26 of the United States Code. All IRC section numbers are the same as the section number in title 26.
2. IRC 1031(a).
3. IRC 280A(d)(1) provides, in part:

   For purposes of this section, a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of—

   (A) 14 days, or

   (B) 10 percent of the number of days during such year for which such unit is rented at a fair rental.

   IRC 280A allows one to occupy the unit for maintenance purposes for up to 10 additional days a year.
4. *Starker v United States,* 602 F2d 1341, 1350 (CA 9, 1979).
5. *Moore v Internal Revenue Comm'r,* TC Memo 2007-134, 93 TCM (CCH) 1275 (2007).
6. 2008-10 IRB 547.
7. *Holmes v Internal Revenue Comm'r,* 184 F3d 536 (CA 6, 1999).
8. *Id.* at 543.
9. *Moore, supra* at 10.
10. See n 4, *supra.*
11. IRS Priv Ltr Rul 8103117 (October 27, 1980). Note, however, that private letter rulings may not be used by the IRS as precedent in court. 26 CFR 601.601(d).
12. *Serdar v Internal Revenue Comm'r,* TC Memo 1986-504, 52 TCM (CCH) 750 (1986).
13. *Id.* at n 13.
14. *Jefferson v Internal Revenue Comm'r,* 50 TC 963 (1968).
15. *Id.* at 968.
16. IRC 280A(e).