



Tax Law

Alert

New IRS Revenue Procedure Allows Like-Kind Exchange for Residential Property

BY CHARLES L. STEEL, IV

For many years there has been no guidance from the Internal Revenue Service with respect to vacation home property and the availability of like-kind exchange treatment under Section 1031 of the Internal Revenue Code. Section 1031 requires that property be held “for productive use in a trade or business or for investment purposes” in order to be eligible for like-kind exchange treatment. In the case of *Moore v. Commissioner*, T.C. Memo. 2007-134, the taxpayers exchanged one lake-side vacation home for another. Neither home was ever rented. Both homes were used solely for personal purposes, but the taxpayers claimed that the exchange of the homes should qualify as a like-kind exchange because the properties were expected to appreciate in value and thus were held for investment purposes. However, the Tax Court found that the properties were held for personal use and that “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.” There have been no clear guidelines on how to convert vacation property into “property held for investment” when a taxpayer desires to exchange one vacation home for another. Practitioners generally have advised listing the property for rental and limiting personal use to the 14 day limit found in Section 280A(d)(1)(A). The question then was how long would the prop-



Charles L. Steel, IV

erty have to be held as “investment property” in order to qualify for like-kind exchange treatment. This left great uncertainty for practitioners in advising clients.

On Feb. 15, 2008, the Internal Revenue Service published Revenue Procedure 2008-16, citing a safe harbor under which the Internal Revenue Service will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment purposes for like-kind exchange treatment under Section 1031 of the Internal Revenue Code. If like-kind exchange treatment is achieved, there is no recognized gain on the exchange of properties, and the adjusted basis of the relinquished property is the substituted basis in the replacement property. Under Revenue Procedure 2008-16, a dwelling unit that a taxpayer intends to be relinquished property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

- (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

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(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.

With respect to the replacement property, a dwelling unit that a taxpayer intends to be replacement property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

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

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

Note that for measuring both 12-month periods, the time period begins the day before and the day after the exchange date. Also, the personal use rules under Section 280A(d)(2) apply for purposes of determining personal use of the residence. Fair rental is determined based on a facts and circumstances test typically looking at the rental amount paid for similar units. Note that the Revenue Procedure is effective with respect to exchanges occurring on or after March 10, 2008 and that the Revenue Procedure applies only to the determination of whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. A taxpayer utilizing the safe harbor in the Revenue Procedure must also satisfy all other requirements for a like-kind exchange under Section 1031 and the Regulations thereunder.

For more information on this topic, please contact any member of our tax law team.

Tax Law Team

Craig L. Rascoe

Chair, Tax Law Team
804.783.6472
crascoe@williamsmullen.com

Farhad Aghdami

804.783.6440
aghdami@williamsmullen.com

Michael J. Bowen

757.473.5323
mbowen@williamsmullen.com

Christine Boronyak Bowers

804.783.6494
cbowers@williamsmullen.com

J. Conrad Garcia

804.783.6910
cgarcia@williamsmullen.com

Montgomery Knight, Jr.

757.629.0622
mknight@williamsmullen.com

Matthew C. Marshall

804.644.9810
mmarshall@williamsmullen.com

Charles B. Neely, Jr.

919.981.4007
cneely@williamsmullen.com

Nancy S. Rendleman

919.981.4034
nrendleman@williamsmullen.com

Robert W. Shaw

919.981.4310
rshaw@williamsmullen.com

Charles L. Steel, IV

919.981.4005
csteel@williamsmullen.com

Maria S. Stefanis

757.629.0664
mstefanis@williamsmullen.com

Heather Hoch Szajda

804.783.6477
hszajda@williamsmullen.com

Please visit

www.williamsmullen.com
for more information about
the Williams Mullen Tax Law
Team.



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