

# TAX UPDATE

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Safe Harbor for Section 1031 Exchanges



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## Section 1031 and Vacation Homes

Confusion over §1031's applicability seems to run rampant among many clients and, unfortunately, sometimes among individuals seeking to give the client advice about handling their affairs with real estate. One key component of confusion is the belief among some individuals that any exchange of real estate will qualify for §1031 treatment.

A taxpayer who operated under this belief was enlightened by the Tax Court last year in the case of *Moore v. Commissioner*, TC Memo 2007-134 where a taxpayer attempted to argue that the existence of a belief that their vacation homes would appreciate caused the properties to have sufficient "investment" status to qualify for Section 1031 treatment. In this case, the court ruled that the primary purpose for holding each property must be investment. Left unanswered, since the facts seemed to clearly demonstrate that little investment

motivation existed at any time, is what level of personal use would kill the ability to use §1031, as well as what period of time for investment motivated holding both before and after the exchange would seem plausible to create a presumption of true investment motivation.

In February, the IRS issued Revenue Ruling 2008-16 in an attempt to give taxpayers a “safe harbor” for property that has had or continues to have personal use, indicating a test that, if met, will cause the property to be deemed to be held for investment for purposes of qualifying for Section 1031.

## Moore Case

The case that started this process running involves a theory I’ve seen suggested to my clients more than once during the real estate boom that existed a couple of years back.

Section 1031(a) establishes the basic criteria for qualifying for a tax free exchange

Sec. 1031 Exchange of property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind

(1) In general

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*.

To qualify for nonrecognition treatment, each property must be shown to be held for either productive use in a trade or business or for investment. As well, there are certain types of assets that are specifically excluded from the applicability of §1031 by §1031(b), notably inventory and partnership interests among others

It’s not unusual to find some individuals who are totally unaware of the business or investment use requirement and believe that Section 1031 applies to all exchanges of real estate<sup>1</sup> no matter why held. Some, not totally ignorant of the

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<sup>1</sup> Note that §1031 says nothing about real estate—it applies to any exchange of property that meets its requirements and that isn’t otherwise excluded under §1031(b). Thus, §1031 governs transactions that involve trade-ins of equipment if both the equipment given up and received meets the trade or business or investment use requirements.

issue, nevertheless decide that so long as there is any belief that the property will appreciate, the “held for investment” requirement is met and the taxpayer can exchange property. Though recent events in the real estate market may have shaken the prior belief that the property will appreciate so long as held at least a week, most buyers still reasonably believe that if they held real estate for the long term it will appreciate. Thus, under this view, we again have all real estate becoming eligible for Section 1031 treatment.

This certainly was the position of Mr. and Dr. Moore in the Moore case that was decided on May 30<sup>th</sup> of last year. Mr. and Dr. Moore in 1988 purchased a property on Clark Hill. The court noted that:

Petitioners' decision to purchase the Clark Hill property was motivated, in part, by their familiarity with the area, both having grown up in the vicinity of Clark Hill Lake. In addition, both their families owned property on or near Clark Hill, and Mr. Moore's father advised them that property on Clark Hill Lake had appreciated and would continue to appreciate. Petitioners' decision to invest in real estate rather than in intangibles, such as stocks or bonds, was influenced by a prior bad experience with a financial adviser who had stolen their money.

The Court outlined the use of that property, which would eventually become the property to be exchanged in the §1031 transaction at issue:

Beginning in late March of each year during which they owned the Clark Hill property, Mr. Moore would spend a couple of weekends there getting it ready for the summer months. Then, beginning in mid to late April, petitioners' family would visit the property two and, sometimes, three weekends a month until Labor Day, when Mr. Moore closed the property for the winter. Between Labor Day and the following March, Mr. Moore would occasionally visit the property to rake leaves and perform other caretaker functions.

The mobile home located on the property was a double-wide mobile home. During their tenure, petitioners built a deck around it, built a screened-in porch on top of a portion of the deck, and installed a satellite television receiver, a new television, and a VHS recorder. They also replaced the roof and repainted the home two or three times. They installed a new washer and dryer and replaced some of the furniture (bedroom seats and beds) that

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And, as well, it's not elective. If Section 1031 applies, the taxpayer must apply its provisions, and it works just effectively to deny current recognition of losses as well as recognition of gains.

had come with the home. They kept a pontoon boat on Clark Hill Lake and improved the dock they had in the lake to conform to the U.S. Army Corps of Engineers electrical requirements. During their summer stays at the Clark Hill property, petitioners and their children used the property for various recreational purposes, including relaxing on the dock, boating, and fishing.

The Moores moved from Norcross, Georgia to Marietta, Georgia in the mid-1990s. The Clark Hill property was a three hour drive from their Norcross home, but the move to Marietta meant that the Clark Hill property was now a five to six hour drive from their home. As well, their son began participating in weekend sports around that time.

The combination of the longer distance and less time to use the property meant that the Moore's use of the Clark Hill property decreased substantially during the years following the move to Marietta. During the two years before they disposed of the Clark Hill property, the court noted they may have only gone to the property three times during the two years before they disposed of it.

Mr. Moore also got out to the property less often to perform maintenance, and according to the opinion, the property began to become rundown. The Moores decided that they either needed to renovate the property or dispose of it—and they chose the latter.

They found a property on Lake Lanier, which was much closer to their Marietta residence. In January 2000 they acquired a property on Lake Lanier, the acquired property in this exchange.

The Court notes the use of the Lake Lanier property as follows:

The Lake Lanier property consisted of a greater than 1.2 acre tract of land, the largest double slip dock allowable on the lake (complete with two lifts), and a house that had five screened-in porches overlooking the lake, a full party deck, a covered veranda, a great room with a stone fireplace, five bedrooms, and 4-1/2 bathrooms. At the time of purchase, the house was partially furnished, and, after purchase, petitioners completed the furnishing themselves. They installed a satellite TV system and a VHS recorder, and, before their second summer at the property, they purchased a motorboat with room for six to eight passengers.

Petitioners and their children engaged in essentially the same activities at the Lake Lanier property as they had at the Clark Hill property. They visited the property two weekends per month beginning in mid-March (depending on the weather) and ending

around Labor Day. In addition, the family might visit the property once or twice each winter, and Mr. Moore and his son would fish off the dock one Saturday night each month during the fall. During the summer months, petitioners occasionally entertained visitors at the house. Mr. Moore's maintenance activities at the Lake Lanier property were similar to, but less frequent than, his maintenance activities at the Clark Hill property.

The Moores always deducted the mortgage interest on the Clark Hill property as home mortgage and not investment interest. As well, no §212 investment related expenses were reported for the Clark Hill property. While they did claim investment interest on at least some of the interest related to the acquisition of the Lake Lanier property, again no §212 expenses were claimed on the Lake Lanier property.

## Appreciation Expectation-Automatic Investment Use?

The taxpayers' position was that so long as investment intent was one motive for holding the property, the requirements of §1031(a) were met and the property qualified. The Court points out that this argument "if carried to its logical extreme, is that the existence of any investment motive in holding a personal residence, no matter how minor a factor in the overall decision to acquire and hold (or simply to hold) the property before its inclusion in an exchange of properties, will render it "property \* \* \* held for investment" with any gain on the exchange eligible for nonrecognition treatment under section 1031."

The Tax Court found that position to be inconsistent with the purpose of §1031 and a number of prior cases on this issue—rather, the key factor is whether the *primary* purpose for holding the property is either for business use or held for investment. Specifically, the court quotes the Ninth Circuit in the *Starker* decision (602 F.2d 1341, 1350-1351 (9th Cir. 1979)) where the Ninth Circuit noted:

It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason, despite the general rule that losses from transactions involving \* \* \* investment properties are deductible. A similar rule must obtain in construing the term "held for investment" in section 1031. \* \* \* [ *Id.*; citations omitted.]

The mere hope that property will appreciate doesn't overcome this issue. While you can convert property to a qualifying use, if you are using expectation of appreciation as the investment purpose, that is only applicable to post-conversion expectation of appreciation. Citing the decision in *Newcombe v. Commissioner* (54 T.C. 1298, 1302 (1970)), the Tax Court noted that if you place

a property for sale shortly after ceasing the personal use, that argues strongly against the existence of a valid conversion to investment use, and is strong evidence there was no expectation of post-conversion appreciation.

The Court notes that there is no other evidence either property was held for production of income or investment. Neither property was ever rented to third parties or made available for rent. The sale of the Clark Hill property was motivated by personal inconvenience rather than investment reasons, and the fact that Mr. Moore did not keep the property up once the personal use ceased argued strongly for no finding of a primary purpose of holding the property for anything but personal use.

As well, while the Lake Lanier property was listed for sale at the time of the case, that was only because the Moores were now involved in a divorce and needed liquidity to effect the split of their assets. Thus, once again, the disposition of the property was not being driven by investment motivations, but again by personal motivations.

## Is All Personal Use Deadly?

So does *Moore* mean that if the taxpayer ever used a property for personal purposes that a Section 1031 is forever foreclosed?

No, as the case makes clear it is possible to legitimately covert personal use property to investment use—but the Moores so clearly fell short of showing such a conversion took place that their exchange failed. In theory, the existence of investment use looks at a taxpayer's motivation, and once that motivation exists (and the property becomes investment use property), the property is immediately eligible for an exchange—there is no holding period requirement for Section 1031 to apply. Similarly, investment property can be converted to personal use, and so long as the investment motivation existed for the received property when it was received, it could be converted seconds later into personal use property if the taxpayer had a true change of motivation.

However, the courts are skeptical when the taxpayer has this change of motivation just before signing the documents to dispose of the property or just after receiving the replacement property, no matter how loudly the taxpayer proclaims his true motivation was investment related as he was signing the contract. As noted above, the court does look at the period of time it appears the taxpayer had the property in “investment mode” following the personal use to try and obtain objective evidence of the taxpayer's primary motive for holding the property.

## New Ruling

The IRS has now given us a “safe harbor” for both use before the exchange and

use following the exchange to allow taxpayers who meet the requirements to be assured the IRS will not challenge the §1031 exchange based on a lack of investment or business use. The IRS does make clear that all other requirements of Section 1031 have to be met, and that the ruling only goes to the question of whether the property was not truly investment or business use property.

Revenue Procedure 2008-16 applies to dwelling units, with those being defined in Section 3.02 of the procedure:

For purposes of this revenue procedure, a dwelling unit is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.

In order to come under this safe harbor, the property must meet the qualifying use standards found in Section 4.02 of the Revenue Procedure. That applies separate tests for the relinquished property and the replacement property.

The relinquished property must meet the following standards:

- Is owned by the taxpayer for at least 24 months prior to the exchange;
- For each of the two 12 month periods immediately preceding the exchange:
  - The property must be rented to another person or persons at fair rental for 14 days or more *and*
  - The taxpayer's personal use during that period cannot exceed the greater of 14 days or 10 percent of the number of days the property was rented at fair value during that period

For the replacement property, a similar forward looking set of requirements must be met:

- The taxpayer must continue to own the property for 24 months following the exchange
- For each of the two 12 month periods following the exchange:
  - The property must be rented to another person or persons at fair rental for 14 days or more *and*
  - The taxpayer's personal use during that period cannot exceed the greater of 14 days or 10 percent of the number of days the property

was rented at fair value during that period

Personal use for these purposes is defined as any day on which the taxpayer is deemed to have used the property for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)). [Section 4.03]

Whether a fair rental is charged is a facts and circumstances test [Section 4.04]. The Revenue Procedure also notes that if a taxpayer files a return reporting an exchange relying on this Revenue Procedure and then finds that the replacement property fails to meet the tests following the filing of the return, the taxpayer should file an amended return and not report the transaction under §1031 [Section 4.05].

The Revenue Procedure will be effective for exchanges of dwelling units occurring on or after March 10, 2008, and no inference is to be drawn on the federal tax implications of exchanges taking place before that date [Section 5].