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IRS Issues New Guidance on Like-Kind Exchanges

The Internal Revenue Service recently issued Revenue Procedure 2008-16 which provides a safe harbor under which the 'Service' will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes under section 1031 of the Internal Revenue Code.

Section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment (replacement property).

A 1959 Revenue Ruling concluded that a gain or loss from an exchange of a personal residence may not be deferred under section 1031 because the residence is not property held for productive use in a trade or business or for investment.

In Moore v. Commissioner, the taxpayers exchanged one lakeside vacation home for another. Neither home was ever rented. Both were used by the taxpayers only for personal purposes. The taxpayers claimed that the exchange of the homes was a like-kind exchange under section 1031 because the properties were expected to appreciate in value and thus were held for investment. The Tax Court ruled, however, that the properties were held for personal use and that 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."

In Starker v. United States, the Ninth Circuit held that a personal residence of a taxpayer was not eligible for exchange under section 1031, explaining that "[it] has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment."

The Service recognizes that many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. In the interest of sound tax administration, the newly issued revenue procedure provides taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under section 1031 even though a taxpayer occasionally uses the dwelling unit for personal purposes.

The Service will not challenge whether a dwelling unit qualifies under section 1031 as property held for productive use in a trade or business or for investment if certain qualifying use standards are met for the dwelling unit. The qualifying use standards addresses (1) Relinquished property and (2) Replacement property.

The relinquished property is a dwelling unit that a taxpayer intends to be relinquished property in a section 1031 exchange 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

   ii. The period of the taxpayer's personal use of 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. For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

The replacement property is a dwelling unit that a taxpayer intends to be replacement property in a section 1031 exchange and 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 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. For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

For purposes of the revenue procedure, personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes. Whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

If a taxpayer files a federal income tax return and reports a transaction as an exchange under section 1031, based on the expectation that a dwelling unit will meet the qualifying use standards for replacement property, and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange under section 1031.

The safe harbor provided in 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 also must satisfy all other requirements for a like-kind exchange under section 1031 and the regulations thereunder.

The revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of the revenue procedure.

If you have any questions, please feel free to contact Vincent Ruocco, LLC, CPA at 203.932.2931.
