



APRIL 17, 2008

Rev. Proc. 2008-16: Safe Harbor for Exchanges of Vacation Homes and Conversions to or from Personal Residences

The Treasury Inspector General for Tax Administration issued a report on September 17, 2007 in which they indicated that clearer direction should be given to taxpayers relative to Vacation Homes and their use in a qualified 1031 Tax Deferred Exchange. The above revenue procedure provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. This revenue procedure follows *Moore v. Commissioner*, T.C. Memo. 2007-134 (the recent vacation home case) which left some confusion and some unanswered questions relating to the Vacation Home and its use in the IRC §1031 Exchange. This safe harbor specifically addresses the vacation home issue, also indirectly appears to address the issue of converting a principal residence into qualifying relinquished property prior to an exchange, or converting a replacement property into a personal residence after an exchange.

As a Revenue Procedure this is just a “safe harbor”. An exchange may still fall outside the parameters outlined in this Revenue Procedure and meet the statutory requirements, but you should expect heightened scrutiny, in an audit, in such a case. This safe harbor will be effective for exchanges occurring on or after March 10, 2008.

Relinquished Property & Replacement Property: Defined as dwelling units qualifying as such relinquished or replacement property in an exchange if it is owned by the taxpayer for at least 24 months immediately before the exchange (in the case of the relinquished property) or after the exchange (in the case of the replacement property), and, in each of the two 12-month periods immediately preceding the start of the exchange or immediately after the exchange in the case of the replacement property:

- (i) The taxpayer rents the relinquished property (in the case of a relinquished property whose use is for vacation purposes) or replacement property (in the case of the replacement property whose use is for vacation purposes) to another person at a fair rental for 14 days or more, and
- (ii) Taxpayer's personal use of the relinquished/replacement property does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the relinquished/replacement property is rented at a fair rental.

Far-reaching Definition of Personal Use. The taxpayer is deemed to have used a dwelling unit for personal purposes if used by:

(A) the taxpayer or any other person who has an interest in such unit, or by any member of the family of the taxpayer (related parties as defined in section 267) or such other person;

(B) any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or

(C) any individual if rented for less than a fair market value rental.

A taxpayer may rent the dwelling unit to a family member if the family member uses it as a *principal* residence (and not a vacation home) and the family member pays fair market rent. Some taxpayer usage may be allowed for repairs and annual maintenance, see Section 280A(d)(2) and (3).

“Fair market rent” is determined based on all of the facts and circumstances that exist when the rental agreement is entered into, and all rights and obligations of the parties to the rental agreement are taken into account. 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.

How Does the Taxpayer Meet the Safe Harbor for a Vacation Home and Principal Residence?

1. **Limit Taxpayer Use.** The taxpayer (inclusive of related parties under section 267, other than as a principal residence) can only use the property for 14 days per year (or 10% of the rental period if greater) for the two years prior to the exchange. The taxpayer may use the dwelling some additional days for repairs and annual maintenance too, but be prepared to prove actual work done.

2. **Rent It Out.** The property also must be rented to unrelated party for at least 14 days per year, but it does not have to be rented more than 14 days per year. (Alternatively, it can be rented as a *principal* residence to a related party).

It appears that a taxpayer can take a personal residence or vacation home, rent it to a friend for 14 days per year for two years and then exchange out of it, with no question about whether it's held for investment. All rent must be fair market and the taxpayer should have evidence to prove this. The taxpayer can do the same thing on the replacement property for the two years after the exchange (and this must be done if the replacement property is also the taxpayer's vacation home or future principal residence).

Any exchange should be undertaken with competent tax advice from your own tax consultant. This publication is not meant to give specific tax advice to any taxpayer. Please consult with your independent tax advisor and your legal advisor when contemplating a tax deferred Section 1031.

Contact the experts at Leverage Exchange Group, LLC at 866-988-1031 or 520.722-2578 for all your Exchange needs.

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