



VACATION HOMES

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

This 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) and the Treasury Inspector General for Tax Administration (TIGTA) report “Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance” (9/17/07), which called for more IRS guidance on vacation home exchanges. The safe harbor, while specifically addressing the vacation home issue, also indirectly addresses 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.

It is just a safe harbor. An exchange may still fall outside the parameters and meet the statutory requirements, but you should expect heightened scrutiny in such a case. The safe harbor is effective for exchanges occurring on or after March 10, 2008.

Relinquished Property

A dwelling unit qualifies as relinquished property in an exchange if it is owned by the taxpayer for at least 24 months immediately before the exchange, and, in each of the two 12-month periods immediately preceding the start of the exchange: (i) The taxpayer rents the relinquished property to another person at a fair rental for 14 days or more, and (ii) the taxpayer's personal use of the relinquished 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 property is rented at a fair rental.

Replacement Property

A dwelling unit qualifies as replacement property in an exchange if it is owned by the taxpayer for at least 24 months immediately after the exchange, and, in each of the two 12-month periods immediately after the exchange: (i) The taxpayer rents the replacement property to another person at a fair rental for 14 days or more, and (ii) The taxpayer's personal use of the 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 dwelling unit is rented at a fair rental. If a taxpayer reports a transaction as an exchange on the taxpayer's federal return expecting that the replacement property will meet the qualifying use standards, but the replacement property does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange.

Broad 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 (including a tenant in common), or by any member of the family of the taxpayer or such other person; (B)



by 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) by 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 too. 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.

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

- (1) **Limit Taxpayer Use.** The taxpayer (any any 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.

Therefore, 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. Likewise, 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).

Source: The Federation of Exchange Accommodators. "Capital Update". FEA Update: Rev. Proc. 2008-16: Safe Harbor for Exchanges of Vacation Homes and Conversions to or from Personal Residences. E-Mail to Members. February 20, 2008