



TREASURY IG URGES MORE OVERSIGHT OF 1031 EXCHANGES

By Ed Horan, *Certified Exchange Specialist*[®]

I have written a number of articles pointing out that there is a great deal of disagreement within the exchange industry over the qualification of vacation and second homes for an IRC 1031 like-kind exchange. In an audit report this past September the U.S. Treasury Inspector General (IG) found that IRC Section 1031 like-kind exchanges are in need of additional oversight to insure compliance with tax laws.

The Treasury IG found that IRS regulations for 1031 exchanges of second and vacation homes are complex and unclear to taxpayers. While it is clear that second homes that are used exclusively by owners for personal use (not rented) are not eligible for like-kind exchanges, there are few clear IRS qualification rules for exchanges of second and vacation homes that are rented part of the time. The IG stated that the absence of clear rules could result in taxpayers incorrectly claiming deferral of gain or underreporting taxes due. The 1031 exchange business has grown substantially over the years and it was noted in the audit that in tax year 2004 taxpayers reported over 338,500 exchanges claiming more than \$73.6 billion of deferred gains. The IRS concurred in the IG report and will try by March 2008 to provide taxpayers with additional guidance on 1031 exchanges of second and vacation homes.

To qualify for a like-kind exchange, IRC Section 1031 requires that both the relinquished property and the replacement property be “held for productive use in a trade or business or for investment.” It is clear a property will fully qualify when it is being held for use in a trade or business. It is accepted within the exchange industry that property only rented and property not personally used over fourteen days or 10 percent of the days rented also will qualify for a 1031 exchange. The basic and most often asked question is – when is a vacation home being held for investment?

In a recent Tax Court case (*Moore et ux v. Commissioner*; T.C. Memo. 2007-134) filed last May, the court examined an exchange of one vacation home for another. Neither home was rented out by the taxpayer, nor held in a trade or business. The court therefore had to rule, as claimed by the taxpayer, if the vacation homes were held for investment under Section 1031.

The first test was that the taxpayer had to show that investment was the primary purpose for holding the vacation property. Then the court used Section 212(2) to equate “held for investment” to “held for the production of income” and examined a number of previous cases. It is very important to note that the court did not apply the “over 14 day personal use rule” set forth in Section 280A and used by many practitioners as the cutoff point for qualifying a vacation property for doing a 1031 exchange. In addition to the primary purpose rule, the court found that just stopping personal use in order to sell the property would not convert the property to investment use.

Also, the court stated the cases under section 212 are applicable to Section 1031 for the "held for investment" interpretation. To rule on the use of the property for investment purposes the court looked to the overall use of the property, what was the primary purpose, how was it maintained, and what efforts were made to produce income. As would be expected, the tax court ruled in this case that the properties were not held for investment. More importantly, the court did provide guidelines for taxpayers to consider when trying to determine if a vacation home qualifies for a 1031 exchange. But until the IRS provides the promised clear guidance as to when or if a second home or vacation property qualifies for a 1031 exchange the issue will continue to be a contentious one. Taxpayers planning to do a 1031 exchange of a vacation home should be certain to consult, in advance, with their CPA or tax advisor.

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This publication is designed to provide accurate information on tax-deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advice is required, the services of a competent professional should be sought.

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