

# Limited Personal Use of Rental Property Won't Negate 1031 Exchange Privilege

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## Background

It's not uncommon for clients to ask tax advisers if vacation homes that have been rented out and also used as personal residences (so-called mixed-use properties) can be swapped in tax-deferred Section 1031 like-kind exchanges. Until now, the honest response was a shrug of the shoulders because there wasn't any clear answer.

As you know, the general rule says you can only swap property that has been held for business or investment purposes for other like-kind property that will also be held for business or investment purposes if you want Section 1031 exchange treatment. [See IRC Sec. 1031(a)(1).] But, nobody was sure if a mixed-used vacation property could qualify as being held for business or investment purposes.

Naturally, some taxpayers took advantage of the vacuum by fearlessly claiming Section 1031 treatment for mixed-use vacation homes that were exchanged for other vacation homes that would also be mixed-use properties. As it turns out, those taxpayers were right! The IRS just ratified the strategy in recently released Rev. Proc. 2008-16. Naturally, however, this good news comes with some limitations. Here's the story.

## Mind the New Safe-harbor Provisions If You Want Certainty

It's clear that a property that has been used (or will be used) only as a personal residence cannot qualify for tax-deferred Section 1031 exchange treatment. (See, for example, Rev. Rul. 59-229, Rev. Proc. 2005-14, and *Moore*.) However, a property that has been rented out and also used in a limited way as a personal residence (or will be used in such a fashion) can qualify under a new safe-harbor established by Rev. Proc. 2008-16. To be eligible for the safe-harbor, the relinquished property and replacement property must meet certain rules.

**Relinquished Property Rules.** The relinquished property (the property given up by the taxpayer in the Section 1031 exchange) must pass both of the following tests.

1. It must have been owned by the taxpayer for at least 24 months immediately before the exchange.
2. Within each of the two 12-month periods within the 24 months immediately preceding the exchange: (a) the property must have been rented at market rates for at least 14 days, and (b) the taxpayer's personal use of the property cannot have exceeded the greater of 14 days or 10% of the days the property was rented at market rates.

For purposes of this rule, the most-recent 12-month period ends on the day *before* the exchange takes place and begins 12 months prior to that day. The earlier 12-month period ends on the day *before* the most recent 12-month period begins and ends 12 months prior to that day.

**Replacement Property Rules.** The replacement property (the property acquired by the taxpayer in the Section 1031 exchange) must pass both of the following tests.

1. It must continue to be owned by the taxpayer for at least 24 months immediately after the exchange.

2. Within each of the two 12-month periods within the 24 months immediately after the exchange: (a) the property must be rented at market rates for at least 14 days, and (b) the taxpayer's personal use of the property cannot exceed the greater of 14 days or 10% of the days the property is rented at market rates.

For purposes of this rule, the first 12-month period begins on the day *after* the exchange takes place and ends 12 months after that day. The second 12-month period begins on the day *after* the end of the first 12-month period and ends 12 months later.

### **What Is Personal Use?**

As you can see, too much personal use of the relinquished property or the replacement property will violate the safe-harbor rules. According to Rev. Proc. 2008-16, a taxpayer personal-use day occurs whenever the property is used for any part of the day:

1. For personal purposes by the taxpayer or by anyone else who has an interest in the property.
2. By a family member of the taxpayer or a family member of anyone else who has an interest in the property. [The term *family member* is defined by IRC Sec. 267(c)(4).]
3. By any individual under an arrangement that allows the taxpayer to use some other property (whether or not the taxpayer pays market rent for using the other property).
4. By any individual who pays less than market rent.

Under an exception, use of the property as the principal residence of anyone (including a family member) who pays market rent doesn't count as personal use by the taxpayer.

**Note:** The personal-use rules are set forth in IRC Sec. 280A(d)(2) and (d)(3). Presumably, the related Section 280A regulations apply too.

### **Property Must Be "Dwelling Unit" to Be Eligible for Safe-harbor**

To be eligible for the new safe-harbor, a property must be a dwelling unit. According to Rev. Proc. 2008-16, that means real property that is improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space and bathroom and cooking facilities. Would a lot with a trailer home qualify? Maybe, but it's unclear. A piece of land that only includes an outdoor camping site apparently would not qualify. Dear IRS: We could use some clarification here.

### **Effective Date**

The safe-harbor established by Rev. Proc. 2008-16 is effective for exchanges of dwelling units that occur on or after 3/10/08. For exchanges before that date, taxpayers are on their own. Although, the new safe harbor certainly provides some comfort. Taxpayers will continue to be on their own for exchanges of mixed-use properties that are not dwelling units (as defined above).

### **Tax Filing Implications**

Say a taxpayer makes a swap that he or she expects to qualify for Section 1031 tax-deferred exchange treatment under the Rev. Proc. 2008-16 safe-harbor. Therefore, the swap is reported as a Section 1031 deal in the return filed for the year of the exchange. Later, it turns out the replacement property doesn't pass the tests explained earlier. In this case, the taxpayer should file

an amended return for the year of the exchange and report it as a taxable transaction. (See Section 4.05 of Rev. Proc. 2008-16.)

### **Conclusion**

Thank you, IRS! While Rev. Proc. 2008-16 isn't everything we could hope for, it's pretty good. We'll take it.

### **References:**

IRC Secs. 267, 280A, and 1031.  
Rev. Proc. 2008-16, 2008-10 IRB.  
Rev. Proc. 2005-14, 2005-1 CB 528.  
Rev. Rul. 59-229, 1959-2 CB 180.  
*Moore, Barry E.*, TC Memo 2007-134.