# 2017 SECTION 1031 TAX FREE EXCHANGE UPDATE

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## I. **Introduction.**

Tax free exchanges, pursuant to Section 1031 of the Internal Revenue Code, continue to be an important part of real estate practice.

In light of the deferred exchange regulations which were issued in 1991, most exchanges now are structured through a "qualified intermediary." This has brought dramatic simplification and added certainty to these types of transactions. This Article will briefly review the rules for effecting an exchange using a "qualified intermediary" and will then address some of the special issues which arise from time to time.

Finally, even though tax free exchanges under Section 1031 have been around for some time, transactions often arise which are in the "gray area" of this statute. Therefore, this Article also reviews some of the rules and some of the issues which are open in this area.

## II. **Review of Section 1031 Rules.**

Under Section 1031(a), no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment, as long as the relinquished property is exchanged only for property of "like-kind" that likewise will be held either for productive use in a trade or business or for investment. There are five requirements for a tax-free exchange.

(1) There must be an "exchange" of relinquished property for replacement property;

(2) Each "property" must not be excluded by statute from potential like-kind exchange treatment; for example, stock in a corporation and partnership interests and inventory held by a dealer are excluded from possible like-kind exchange treatment;

(3) The replacement property must be "of like-kind" to the relinquished property;

(4) Both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment; and

(5) The acquirer of the replacement property must be the same as the seller of the relinquished property.

## III. **Review of Qualified Intermediary Rules For "Deferred Exchanges."**

Most exchanges are "deferred" exchanges. That is, property (the "Relinquished Property") is sold by the seller, and the seller later acquires property ("Replacement Property") from someone else to constitute the exchange. The purpose of the "qualified intermediary" is to provide a "straw man" for the transaction and to hold the seller's money from the time the Relinquished Property is sold until the new Replacement Property is bought. Here are the mechanics:

1. Taxpayer enters into a Sales Contract for the sale of the Relinquished Property.

2. Taxpayer enters into a Qualified Intermediary Exchange Agreement (before the sale of the Relinquished Property) with a qualified intermediary. (We have found that it is easy and convenient to use one of the local title insurance companies or banks as a qualified intermediary for this purpose).

3. Taxpayer assigns the Sales Contract, for the sale of the Relinquished Property being sold, to the qualified intermediary under the terms of the Qualified Intermediary Exchange Agreement.

4. Taxpayer must notify the buyer in writing (before the sale of the Relinquished Property) of the assignment of the Sales Contract to the qualified intermediary, and the buyer must acknowledge, in writing, receipt of Notice of the Assignment of the Sales Contract.

5. At the closing of the sale of the Relinquished Property, the proceeds must be paid **directly** to the Qualified Intermediary. It is very important that the proceeds are not payable to the Taxpayer or a person who might be considered the Taxpayer's agent.

6. The Taxpayer/Seller must "identify" the property the Taxpayer/Seller wishes to acquire in exchange for the Seller's property (the "Replacement Property"). This identification must be done within 45 days of the date Taxpayer/Seller conveys his Relinquished Property.

The identification must be done in writing strictly in accordance with the IRS rules. The Taxpayer/Seller may identify up to **three (3) properties** from which the Taxpayer/Seller may later choose. The Taxpayer/Seller may also identify as many properties as Taxpayer/Seller wants to identify - so long **as the "total value" of all identified properties does not exceed 200% of the fair market value** of the Relinquished Property – but, who knows what "total value" means?

7. The Taxpayer/Seller enters into a Purchase Contract for the Replacement Property that the Taxpayer/Seller desires to acquire.

8. The Purchase Contract for the Replacement Property must then be "assigned" to the Qualified Intermediary.

9. The seller of the new Replacement Property must be notified in writing (and before the sale) of the assignment of the Purchase Contract to the Qualified Intermediary, and the seller of the Replacement Property must acknowledge, in writing, receipt of the Notice of Assignment of the Purchase Contract.

10. Taxpayer closes the purchase of the Replacement Property. This must be completed by the **earlier of** the following dates: (i) 180 days after the sale of Taxpayer's property, or (ii) the due date for filing the taxpayer's tax return for that year (normally April 15 of the following year – unless the taxpayer files an Extension Application to extend the filing due date).

11. Notification is issued to the Qualified Intermediary to instruct the Qualified Intermediary to release the proceeds to the Seller to purchase the Replacement Property.

12. Title to the Replacement Property must be conveyed to the exact same person or entity that owned (and sold) the Relinquished Property. For example, if only the Husband's name was on the deed to the Relinquished Property, then the Replacement Property must not be deeded into the names of Husband and Wife; instead, the Replacement Property must be deeded to the Husband only.

13. For the tax year the Taxpayer effects the like-kind exchange, the Taxpayer must file IRS Form 8824 together with Taxpayer's tax return.

It is very important that each of these steps be timely. For example, the entry into the Qualified Intermediary Exchange Agreement must occur before the sale of the Relinquished Property. Also, the Assignments and Notices must occur before the sale or purchase of Relinquished or Replacement Properties, as the case may be.

**IV. Special Section 1031 Issues: Frequently Asked Questions (FAQs).** Here are some frequently asked questions concerning the Section 1031 rules:

**1. What if the purchase price of my replacement property is less than the sales price of my relinquished property?** In an exchange, you must pay tax on the lesser of any cash received in the exchange or the amount of the gain on the sale. This means that, where the Taxpayer's purchase price on the Replacement Property is less than the sales price of the Relinquished Property, the Taxpayer must pay tax on the difference between the sales price of the Relinquished Property and the purchase price of the Replacement Property. Also, the amount of the gain **is not reduced** by any of the Taxpayer's tax basis in the Relinquished Property.

**2. What happens to my tax basis in my Relinquished Property?** The Taxpayer's income tax basis in the Relinquished Property is "rolled into" his tax basis in the new

Replacement Property. This means that any gain not recognized on the sale of the Relinquished Property is deferred until the Replacement Property ultimately is sold.

**3. What if the Taxpayer's mortgage is paid as part of the sale of the Relinquished Property?** Generally, when property subject to a mortgage is sold, the buyer insists that the mortgage be paid out of the sales proceeds at closing. Accordingly, a debt of the Taxpayer is paid. Does this mean the Taxpayer is in "constructive receipt" of cash?

> Example: Taxpayer owns Relinquished Property with a basis of $50,000 and a mortgage of $250,000. The Relinquished Property is sold in an exchange transaction for $400,000. At the closing, the mortgage is paid.

Clearly, the taxpayer will have to replace the Relinquished Property with Replacement Property costing at least $400,000 in order to avoid the recognition of any gain. Interestingly, the regulations specifically address the situation where exchanged Replacement Property is sold subject to a mortgage, in other words, where the mortgage is assumed by the buyer. In that case, the regulations make clear that, so long as the taxpayer acquires replacement property subject to a mortgage of a like amount, the boot paid offsets the boot received. Treas. Reg. § 1.1031(b)-1(c). Although this is helpful, it is also a fairly uncommon transaction because, as noted above, mortgages are almost always paid off. Logically, the payment of a mortgage should have the same result as the assumption of a mortgage. See Commissioner v. North Shore Bus Co., 143 F 2d 114 (Second Cir. 1974).

**4. Is it possible to receive an installment note and still do a like-kind exchange?** Sometimes, the buyer of the Relinquished Property gives the Taxpayer an installment note for part or all of the sales price for the Relinquished Property. The installment note has certain advantages in that taxation is deferred until the receipt of the note payments. However, in a Section 1031 transaction, the note represents boot, and, accordingly, the note itself (or the proceeds of the note) will cause gain to be recognized.

> Example: Taxpayer's property has a basis of $50,000. She has arranged to sell the property for $200,000. The Taxpayer is to receive $75,000 in cash and a note for $125,000. The Taxpayer exchanges the property (through a qualified intermediary) for $200,000 of Replacement Property. The Taxpayer has received $125,000 in boot and will have to recognize gain (on the installment method) accordingly.

An interesting planning opportunity arises under a quirky regulation dealing with the interplay of the installment sales rules and Section 1031. Under Temp. Treas. Reg. § 15A.453-1(b)(3)(i), the receipt of proceeds from a qualified escrow account or qualified intermediary in a failed exchange is treated as a payment on an installment obligation. This is the case, however, only if the taxpayer has a "bona fide intent" to exchange at the beginning of the transaction.

This is interesting, for example, where a transaction occurs in 2015 and that there is no acquisition of exchange property, and where the proceeds will be received from the qualified intermediary or from the escrow account in 2016. Accordingly, the proceeds should be taxable in 2016. This has the effect of deferring taxation on the payment and possibly shifting the payment into a year with a lower tax rate. It is not clear how encumbered properties fit into this system.

**This is another reason why it is a good idea to structure sales as exchanges - even if the taxpayer is not sure whether she wishes to proceed with the exchange.**

**5. Can an exchange be combined with a foreclosure situation?**

Example: Taxpayer purchased improved real property for a $200,000 promissory note. Later, after many years of depreciation, the taxpayer's basis in the property is almost zero, and the taxpayer has elected to give the property back to the noteholder. It appears that the transfer of the property back to the noteholder can be structured as a Section 1031 exchange. However, in order to completely defer recognition of gain, the taxpayer would have to use a qualified intermediary in order to acquire Replacement Property worth at least $200,000.

**6. Suppose the taxpayer must acquire Replacement Property now, but is not in a position to sell his Relinquished Property until later on?**

Example: Taxpayer has identified an apartment building that he wishes to acquire in a Section 1031 exchange. Taxpayer is also planning to sell an office building he has owned for some time. For business reasons, Taxpayer must close on the purchase of the apartment building within thirty days. However, he has not yet found a buyer for the office building. What are the options?

**a. Leasing.** Where the taxpayer must acquire the replacement property first (that is, before the taxpayer is prepared to sell the exchange relinquished property), one alternative is for the taxpayer to simply lease the replacement property from the seller. The seller will generally demand a lease payment equal to his "carrying costs" for the replacement property. Of course, the seller will also want to ensure that he has a deal. One way to effect this is to grant the seller a “put” right, which allows the seller to require the taxpayer to purchase the replacement property from the Seller.

Similarly, the taxpayer will want to secure an option to purchase the replacement property. This all leaves a lease of the replacement property with a fair market rent, but allowing the taxpayer/lessee with an option to purchase the replacement property and the lessor a "put right" to require that the taxpayer/lessee purchase the property.

The concern with this is that the IRS may take the position that such a lease is, for all intents and purposes, a conveyance of the property to the taxpayer. Therefore, the same property could not be later received in an exchange. One possible technique in this situation is to grant the lessee an option to purchase the replacement property at whatever the agreed upon value is. If the taxpayer/lessee does not exercise the option by a outside date, the rental is increased substantially. Hopefully, the increased rental protects the seller/lessor and also provides a motivation to the buyer/lessee to exercise the option and purchase the property.

b. **Revenue Procedure 2000-37 Now Allows A "Safe" Harbor For Reverse Like-Kind Exchanges Through The Use Of The "Qualified Exchange Accommodation Arrangement" (QEAA).** The QEAA arrangement is facilitated by a "exchange accommodation title holder" (EAT). The following steps illustrate how the QEAA arrangement with an EAT must be structured under the "reverse" exchange safe-harbor:

1. The EAT (such as a title company or other unrelated party) would create a single-member limited liability company. The seller of the replacement property would then transfer the replacement property to the LLC (or the taxpayer would transfer the relinquished property to the LLC).

2. At the time replacement property is transferred to the EAT, LLC, the taxpayer must intend to complete a Section 1031 exchange.

3. Once the EAT, LLC acquires ownership of the replacement property (or the relinquished property), that ownership must continue uninterrupted until the replacement property is ultimately transferred back to the taxpayer and, during this time, the EAT must be treated as the beneficial owner of the property for all federal income tax purposes, and both parties must report the federal income tax attributes of ownership of the property on their federal returns consistent with this arrangement.

4. Within in five business days after the relinquished or replacement property is transferred to the EAT, the taxpayer and the EAT must enter into a written QEAA which provides as follows:

   (a) The EAT is the "beneficial" owner of the property for the benefit of the taxpayer to facilitate a Section 1031 exchange under Revenue Procedure 2000-37;

   (b) The parties agree to report the acquisition, holding and disposition of the property as provided in Revenue Procedure 2000-37; and

   (c) The taxpayer and the EAT must treat the EAT as the beneficial owner of the property for all federal income tax purposes.

5. No later than 45 days after the transfer of the Replacement Property to the EAT, the taxpayer must "identify" his Relinquished Property as property to be sold in the reverse exchange.

6. Within 180 days after the transfer of the Replacement Property's ownership to the EAT, the taxpayer's Relinquished Property must be transferred to the purchaser; and

7. The combined time that the Relinquished Property and the Replacement Property are held by the EAT cannot exceed 180 days.

Fortunately, the new safe-harbor Rev. Proc. will permit the parties to enter into appropriate financing arrangements to facilitate the reverse exchange. For example, the taxpayer may guarantee obligations of the EAT, and may loan funds to the EAT to acquire the Replacement Property. Likewise, the EAT may lease Replacement Property to the Taxpayer during the 180 day exchange period, and during this time, the Taxpayer may manage property held by the EAT or supervise any construction of improvements on the property held by the EAT.

**7. What if the Taxpayer desires to <u>build</u> Replacement Property?**

<u>Example</u>: Taxpayer owns an apartment complex that he wishes to exchange for a vacant lot. He then plans to construct a golf course on the vacant lot. The apartment complex will be sold for $325,000. The Taxpayer needs $100,000 to purchase the vacant lot and $225,000 to complete the improvements for the golf course.

The Taxpayer can still effect a Section 1031 exchange if he allows the sales proceeds to be placed with a qualified intermediary. The vacant lot would be actually acquired by the qualified intermediary and the qualified intermediary would construct the improvements. The Taxpayer would then acquire the improved property from the intermediary. Note that this must be done before the close of the 180 day period. See PLR 9413006. Note also the complicated requirements for identifying Replacement Property to be constructed. Treas. Reg. § 1.1031(k)-1(c)(2)(i).

Sometimes, the building of Replacement Property must be combined with the "reverse exchange" described in 6 above. That is, the client wants to acquire land and construct improvements and later sell his property. In this case, a similar analysis applies. We think that the qualified intermediary must purchase the land and also build the building. Later, after the taxpayer has completed the sale, he can exchange into the land and building then owned by the qualified intermediary. Obviously, this raises many complications.

Care must be taken in identifying property which is to be constructed. The regulations require that the constructed property be identified with particularity and that the property actually receive the "substantially the same property as identified." Reg. § 1.1031(k)-1(e)(3)(ii). It is also important to note that, once property is actually received by the taxpayer, subsequent construction does not "count" towards the exchange. Reg. § 1.1031(k)-1(e)(4).

**8. I already have signed a contract to sell my property. Is there anything I can do?** Yes. Especially with the qualified intermediary rules, it is still possible to enter into a qualified intermediary agreement and assign the Sales Contract to the qualified intermediary. It would be helpful if a provision allowing this were built into the Sales Contract, but if it is not, the buyer of the property should really not have an objection provided he is delivered good title. However, it is absolutely critical that the qualified intermediary arrangement be entered into before the closing of the client's sale of the Relinquished Property.

**9. What if property identified somehow changes before it is acquired?** Sometimes, property which is received is not exactly equivalent to that which is identified. For example, where the identification is of a piece of property to be subdivided, the taxpayer may identify what he thinks will be the ultimately subdivided piece of property. However, sometimes the subdivision authority may impose requirements which requires the property to be of a different configuration of that identified.

Under the regulations, the property received must be "substantially the same property identified." In one example in the Treasury Regulations, a fence was erected on identified property between identification and receipt. Reg. § 1.1031(k)-1(d)(2). The example says that because the fence did not alter the basic "nature or character" of the property, it does not affect the identification/receipt issue. However, it is not clear what would happen if more substantial improvements were effected. Suppose, for example, the taxpayer identified a particular acre of land and after the identification a building were constructed on the land?

In another example, two identified acres were reconfigured so that only one and one-half acres were conveyed. Reg. § 1.1031(k)-1(d)(2). In this example, the IRS was OK with the identification because the one and one-half acres was "substantially the same property as identified" because the property received did not "differ from the basic nature or character" of the identified property. Thus, it seems that, for example, a particular shopping center outparcel should be identified and later received as exchange property even if it were later changed. However, it would not be possible to substitute a completely different piece of property.

**10. After an exchange, I enter into an agreement to buy property. What should I look out for?** As noted above, the contract for purchase of the Replacement Property must be assigned to the qualified intermediary. Therefore, there should be a provision in the Purchase Contract which permits this assignment. Sometimes, sellers may be reluctant to allow an assignment because they don't want the buyer to be able to get "off the hook" in the event the buyer changes his mind.

**11. I received a 1099 with regard to property I recently exchanged. How should I handle this?** The 1099 should be disclosed on the tax return in order to avoid a problem with IRS matching procedures.

**12. What are the reporting requirements?** Exchanges should be reported on Schedule D or Form 4797 (which ever is applicable). Also, Form 8824 must be completed. Form 8824 contains information with respect to deferred gain and basis.

**13. Now that capital gains rates have been cut, should I still consider doing a Section 1031 exchange?** Theoretically, the reduction in capital gains rates will make exchanges slightly less attractive. This is because, in analyzing the exchange, the tax to be paid will be somewhat less so that the exchange is comparatively less favorable. However, taxes on unimproved real estate still represent 25% of the gain and where depreciation recapture is involved, more like 30%. Therefore, we think exchanges will have continued vitality.

**14. How can I use a "one-owner" LLC to assist in my exchange?** Because a one-owner LLC is disregarded for federal tax purposes, it is logical to assume that a person selling property can exchange into replacement property using a single person LLC to acquire title. This is because if the LLC is ignored, the person will be deemed (for tax purposes) to have acquired the replacement property himself or herself. This was confirmed in a prior IRS Private Letter Ruling, PLR 9807013.

**15. Beware of Special Rules Regarding Depreciation Recapture!** "Depreciation recapture" under Sections 1245 and 1250 is **<u>not</u> <u>eligible</u>** for Section 1031 tax-free exchange treatment. The tax laws provide complicated rules for determining the amount of "depreciation recapture" **<u>not</u> <u>eligible</u>** for Section 1031 treatment depending upon the nature of the real property involved and the year the property was placed in service. For example, for non-residential real property placed in service after 1980 and before 1987, all accelerated ACRS depreciation is subject to Section 1250 recapture. On the other hand, for residential real property, only the excess of ACRS depreciation over straight-line depreciation is subject to the Section 1250 recapture rules. **Thus, you should contact your CPA to determine whether your real property may be subject to the depreciation recapture rules.**

**16. What if I am a partner/shareholder in an entity that owns the real property to be sold?** Special Section 1031 problems arise whenever the relinquished property is held in a partnership, corporation or LLC and where not all shareholders or partners of the owner-entity want to engage in a Section 1031 exchange. In these cases, it may not be possible to structure a Section 1031 exchange -- unless ownership of the real property is restructured long before the contract for sale is entered into. Therefore, if the property you want to exchange is held in a partnership, corporation or LLC, you should contact your legal and tax advisors to determine whether you will still be eligible to engage in a Section 1031 exchange transaction.

**17. What if I want to acquire a "tenants-in-common" interest in a piece of Replacement Property with another owner?** The Section 1031 rules specifically state that Section 1031 tax free treatment does not apply to exchanges of "partnership interests." In some cases, a taxpayer owns a tenants in common interest that will be sold as relinquished property, or wants to acquire a tenants in common interest as replacement property. The question is whether the tenants-in-common ownership arrangement between the taxpayer and the other owner is a partnership or true tenancy. Unfortunately, the Section 1031 exchange rules set forth in the Tax Code do not attempt to define the terms "partnership interest" or the term "tenancy-in-common interest." Instead, tax practitioners who practice in the Section 1031 area are forced to look to other provisions of the Tax Code in order to determine how a court of law might (or might not) construe the Section 1031 prohibition against exchanging property for partnership interests.

To this end, the regulations to IRC Section 761 state that the mere co-ownership and rental of property does not constitute a partnership. However, if the taxpayer anticipates having to also provide repairs, maintenance, cleaning, laundry and other tenant services, these additional services may make the tenancy a partnership, even if these services are provided through a third party management agency. Therefore, you should consult with your tax advisor to determine whether your tenancy interest may be construed to be a tenants-in-common interest or a partnership interest.

**IRS Ruling Guidelines on Co-Ownership Arrangements**. The IRS may have finally awakened to this issue. In Rev. Proc. 2002-22, the IRS specifies the conditions under which it will consider a request for a ruling that an undivided fractional interest ("UFI") in rental real estate is not an interest in a business entity within the meaning of Reg. 301-7701-2(a). The IRS will not consider a request for ruling under Rev. Proc. 2002-22 unless certain specific information is provided by the taxpayer and all the conditions outlined in the revenue procedures are satisfied.

**18. Can I sell my vacation property and defer the gain under Section 1031 and or can I sell my investment property and use the sales funds to buy vacation property in a 1031 exchange?** Section 1031 requires that the property sold, and the replacement property purchased, both must be "trade or business" property or property "held for investment" purposes. Thus, nonrecognition under §1031 is premised on the receipt of like-kind property to be held for productive use in trade or business or for investment. Thus, for example, an exchange of investment property for other real estate to be used solely as a personal residence would not qualify. The IRS has taken the position in a letter ruling that such property will qualify as eligible property for purposes of §1031 only to the extent that the taxpayer would have been permitted deductions under §280A. PLR 8508095.

Of course, a taxpayer may own property which he uses partially for investment purposes and partially for personal purposes; for example, a condominium unit in a resort setting might be used by the taxpayer for vacation or personal purposes. In PLR 8103117, the IRS ruled that mere incidental personal use will not taint otherwise qualifying property.

Therefore, if you use your sales proceeds to purchase vacation property, it is possible the IRS will challenge your exchange on the basis that you have purchased "personal use" rather than "investment" property.

**a. Barry Moore vs. Commissioners.** Recently, in the case of Barry Moore v. Commissioner, TC Memo 2007,-134 (May 30, 2007), the Tax Court considered whether the Moore family could claim Section 1031 treatment on their sale of certain lake front property for other lake front property where both properties were used by the Moores primarily for recreational purposes. In this Tax Court case, Mr. Moore presented evidence at the Tax Court trial that he purchased the relinquished and replacement properties for investment purposes; however, the facts also demonstrated that the Moores used the relinquished and replacement property primarily for recreational purposes. Ultimately, the Tax Court concluded that, although Mr. Moore contended that he purchased the replacement and relinquished property in hopes that those properties would appreciate in value, this was not sufficient to bring the replacement and relinquished properties within the parameters of Section 1031.

Instead, the Tax Court held that, in order for the Section 1031 requirements to be met, the Moores would have to prove that the **primary** purpose of their purchase was to earn rental income or to recognize appreciation in value. Unfortunately, the facts bore out that the Moores purchased and used both properties primarily for recreational purposes rather than for investment purposes. Therefore, the 1031 relief was not available since neither the relinquished property nor the replacement property were held for "primarily" for investment purposes.

**b. IRS Safe Harbor for Certain Limited Vacation Use.** In early 2008, the IRS issued Rev. Proc. 2008-16 (February 15, 2008) in response to the Barry Moore case, and created a new "safe harbor" for like-kind exchanges of vacation homes and other rental property. The general thrust of the new Revenue Procedure 2008-16 is that the IRS will not challenge a vacation home as qualifying for purposes of Section 1031 (as property held for productive use in a trade or business or for investment ) if the home is only occasionally used by the taxpayer for personal use and its predominant use is to generate rental income. The rental income must be bona fide and at fair rental value.

The new safe harbor under Rev. Proc. 2008-16 addresses both relinquished property and replacement property, and the following requirements must be met:

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a §1031 exchange 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 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 the 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 preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) Replacement property. A dwelling unit that a taxpayer intends to be replacement property in a §1031 exchange 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 the 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 new safe harbor provides valuable planning opportunities because now we have a "bright line" test for determining whether vacation homes qualify as investment property for Section 1031 purposes. Before the new ruling, clients would often ask:

- “When must I stop using my vacation home before I sell it in a 1031 exchange?"

- "How long do I have to rent the replacement property out before I can convert it to personal use purposes?"

Now, we can answer that the safe answer would be “two years.”

## V. **Conclusion.**

This Article provides some of the basic rules for understanding like-kind exchanges.

However, you should note that, although the IRS has issued some fairly specific regulations, there are still many issues which are unresolved. These regulations have only been around since 1991 which is a very recent year in the tax world. This means that there are virtually no cases or rulings which provide additional guidance on like-kind exchanges. Therefore, no one can predict what the IRS might argue on audit or how the IRS or courts might rule in the future.

Of course, you should feel free to call anyone at Carruthers & Roth, P.A. if you have a question or concern about your like-kind exchange at any time.