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Corporate Title Exchange Services *Est. 1995*

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Did you know?

We have received numerous calls lately from taxpayers wanting to defer capital gains on their second or vacation home. Just as a reminder/refresher on information that we brought you in 2008**:** In February of 2008, the IRS issued Revenue Procedure ("Rev. Proc.") 2008-16, effective for exchanges occurring on or after March 10, 2008, which provides a safe harbor for exchanges of vacation homes ("dwelling unit"). Taxpayers must satisfy qualifying use standards during the 24-month period prior to the exchange.

Relinquished Property

For a dwelling unit to qualify as relinquished property, it must meet the following criteria:

1) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); **and**

2) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:
   a) the taxpayer rents the dwelling unit at fair rental to another person or persons for 14 days or more and
   b) 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 fair rental.

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).

Replacement Property

For a dwelling unit to qualify as replacement property, it must meet the following criteria:

1) It is owned by the taxpayer for at least 24 months immediately following the exchange ("qualifying use period"); **and**
2) Within the qualifying use period, in each of the two 12 month periods immediately after the exchange:
   a) the taxpayer rents the dwelling unit to another person or persons at fair rental for 14 days or more and
   b) 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 was rented at fair rental.

The 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.

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Rental Equipment Fails to Qualify for Exchange Treatment

On June 25, 2010 the National Office of the Chief Counsel of the IRS issued **Chief Counsel Advisory (CCA) 201025049.** This Advisory concluded that the taxpayer's rental equipment did not qualify for depreciation under IRC § 167 nor did it qualify for like-kind exchange treatment under IRC § 1031.

In this particular case, the Taxpayer was in the business of selling, renting, servicing, and financing equipment. When it ordered equipment from the manufacturer, it designated that equipment as either for sale or for rent and when received, it capitalized the cost, which was depreciated pursuant to IRC § 167.

In some cases, equipment that was initially designated as rental was sold later to a renter or other purchaser. When the rental equipment was sold, it was exchanged for new rental equipment through a Qualified Intermediary pursuant to an LKE program. Approximately 91% of the revenue came from sales and only 9% from rentals in the tax year examined by the IRS. In addition, many items designated as being held for rental purposes were disposed of very quickly after acquisition and none were rented prior to disposition. In fact, 40% of taxpayer's rental equipment was disposed of during the year and half of those dispositions occurred within 90 days of receipt.

Based on these facts, the Chief Counsel concluded that equipment designated as rental was not "held for use in a trade or business or for investment" but rather, it was held primarily for sale. As such, the property was deemed ineligible for depreciation under IRC Section 167 and for tax-deferral under IRC § 1031 (specifically pursuant to IRC § 1031(a)(2)(A), exclusion for stock in trade or other property held primarily for sale). The Chief Counsel noted that temporarily withdrawing property from inventory or incidental use of inventory (such as an automobile dealer using a car as a demo) does not convert the property from inventory into property used in the ordinary course of business.

This Advisory determination is fact specific and is not binding on the IRS, any court or on any other party, but does provide a view of the IRS relative to the topic.

ILM 201013038 (April 2, 2010): Acquisition of Replacement Property Equipment from Related Party Dealer Violates Section 1031(f)

Keeping on the "Equipment track", in a Chief Counsel Advice Legal Memorandum, the IRS advised that a heavy equipment lessor could not acquire replacement property (RP) in an exchange from its related party dealer when the buyer of the relinquished property (RQ) was an unrelated party. The IRS ruled that the particular transaction was structured (in part) to avoid the § 1031(f) restrictions on exchanges between related parties. Further, the taxpayer did not establish that the transaction met the § 1031(f)(2)(C) exception to the restrictions on exchanges between related parties.

In this case, a Dealer sold a specific brand of equipment at retail. Taxpayer, a related party to the Dealer under IRC § 267(b), leased that type of equipment to unrelated customers in the course of its trade or business. Under a master exchange agreement (see Rev. Proc. 2003-39), the Taxpayer used a QI to exchange its old equipment for new equipment acquired from the Dealer. There was basis shifting involved in the transactions because the Dealer sold inventory into the exchange at its cost (realizing no gain), while the Taxpayer attempted to defer its gain from the disposition of RQ by taking a substituted basis (the high basis of RP for the low basis of RQ). **Red Flag**: Basis Shifting!

This transaction fell within § 1031(f)(4) and Rev. Rul. 2002-83 and therefore was an invalid exchange unless Taxpayer could demonstrate that tax avoidance was not one of Taxpayer's principal purposes for structuring the transaction as an exchange. Some legislative historical examples of **non** tax avoidance exceptions include: an exchange of undivided interests, a disposition of property in a nonrecognition transaction by one of the related parties, or a non basis-shifting transaction.

In this case, the Taxpayer's exchange clearly resulted in basis shifting and did not fit within the listed exceptions. Although the Taxpayer stated it had independent business reasons for acquiring its RP from the related Dealer, the Taxpayer admitted that it could have obtained the RP property directly from the unrelated manufacturer or unrelated dealer, but did not choose to do so. And, while the Taxpayer cited its independent business reasons as evidence that tax avoidance was not its sole objective, 1031(f)(2)(C) excepts transactions only if none of the principal purposes for the structure is tax avoidance. Even though the Taxpayer may have had some non-tax-avoidance reasons for structuring the exchange, immediate tax reduction was one of Taxpayer's principal objectives.

The above is merely an overview and is not to be construed as tax advice. A taxpayer should always consult his/her tax advisor to determine the treatment of all of your costs associated with the relinquished and replacement property closings and to determine the exact amount the taxpayer needs to reinvest to fully defer his/her gain.

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Personal Use. Use by the taxpayer or other person having an interest in the dwelling unit and any family member (includes siblings, spouse, ancestors and lineal descendants) will be considered "personal use" by the taxpayer. Also, any arrangement whereby fair market rent is not paid will be considered "personal use" by the taxpayer. However, use by family members will not be considered "personal use" by the taxpayer if the dwelling unit is rented at fair market rent and the family member uses it as his principal residence.

Fair rental. Fair rental is determined based upon all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the rental agreement are taken into account.

Special rule for replacement property. If the taxpayer files a return reporting a transaction as an exchange under §1031 based on the expectation that the dwelling unit will meet the qualifying use standards and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange under §1031.

Exchanges of 2nd/vacation homes outside the Rev. Proc. 2008-16 safe harbor. An exchange of a vacation home may still qualify under §1031 even though it falls outside the parameters of Rev. Proc. 2008-16. Any such circumstance will be subject to greater scrutiny and therefore should be carefully planned and reviewed by the taxpayer's tax advisor.

Other Recent Letter Rulings, Regulations, Announcements, etc

Goolsby v. Commissioner (April 1, 2010); T.C. Memo. 2010-64

The Tax Court certainly followed the Rev. Proc. in ***Goolsby v Commissioner***. The Tax Court found that property acquired by taxpayers did not qualify as replacement property when the taxpayers moved into the property two months after acquiring it. In October 2002, the taxpayers signed a purchase agreement contingent upon sale of taxpayers' personal residence in California, to acquire a single family property in Georgia (the Pebble Beach property). In February 2003, the taxpayers sold their principal residence in California and began living with their in-laws in Georgia. In March 2003, taxpayers sold their rental property located in California and using a Qualified Intermediary to structure a 1031 exchange, acquired the Pebble Beach property as replacement property.

The following was reviewed by the court when rendering its decision to disallow the exchange:

- The taxpayers moved into the Pebble Beach property two months after acquiring it.
- Their efforts to rent the Pebble Beach property were minimal, rental advertisements were only placed in a local paper for a few months no other efforts were made to gain more exposure for the Pebble Beach property.
- The taxpayers began preparations to finish the basement of the Pebble Beach property and had permits pulled for construction, within two weeks of purchase.
- The taxpayers made the purchase of the Pebble Beach property contingent upon sale of their personal residence in California.
- The taxpayers sought advice from the QI regarding whether they could move into the property if renters could not be found.
- The taxpayers did not research whether homeowners association restrictions would allow for rental of the Pebble Beach property before the exchange and did not research rental opportunities in the area prior to the exchange.

The court ruled that taxpayers did not intend to hold the Pebble Beach property for productive use in a trade or business or for investment at the time of exchange, and therefore it was not valid replacement property. It also found the taxpayers liable for the accuracy related penalty due to a substantial understatement of tax.

"Your 1031 Exchange Specialist"

Certified Exchange Specialist on Staff

Should you have any items which you would like to see addressed, we welcome your feedback.

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