

The IRS today issued Rev. Proc. 2008-16, which 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 for purposes of Section 1031. This safe harbor is a follow up to the Inspector General report that highlighted deficiencies in the IRS' handling of such exchanges.

Under Rev. Proc. 2008-16, a dwelling unit that a taxpayer intends to be relinquished property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if: (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, the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and 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.

The replacement property must meet the same test. Thus, a dwelling unit that a taxpayer intends to be replacement property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if: (1) the dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and (2) within the qualifying use period, in each of the two 12-month periods immediately after the exchange, the taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and 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.

Rev. Proc. 2008-16 is effective for exchanges of dwelling units occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of this revenue procedure.

This revenue procedure will provide a bright line test for taxpayers wishing to know for certain whether a residence will qualify. However, there will be a number of cases where the holding period or the rental period is too short to qualify for the safe harbor.