MEMORANDUM

To: ABA Leadership

From: Dennis M. Horn,
ABA Advisor for NCCUSL Uniform Law Project

Dated: December 4, 2007

Re: Real Estate Transfer on Death Deeds

What is a Transfer on Death Deed:

Probate is an expensive process, both in the court resources used and in expenses to the litigants. Under the leadership of the ABA and the National Conference of Commissioners on Uniform State Laws (NCCUSL), states have promulgated laws authorizing will substitutes for the transfer of property at death without probate. Examples of assets that today routinely pass outside of probate include the proceeds of life insurance policies and pension plans, securities registered in transfer-on-death (TOD) form, and funds held in pay-on-death (POD) bank accounts.

A new device, the Transfer on Death deed (TOD deed), is designed to transfer real property upon the death of the owner without encumbering the real property during the owner's life and without probate. By executing and recording a TOD deed, an owner may designate a beneficiary or beneficiaries to receive the property at the owner's death without waiting for probate and without the beneficiary designation needing to comply with the witnessing requirements of wills. By these deeds, the owner identifies the beneficiary or beneficiaries who will succeed to the property at the owner's death. During the owner's lifetime, the beneficiaries have no interest in the property, and the owner retains full power to transfer or encumber the property or to revoke the TOD deed.

NCCUSL Timetable:

Ten states currently authorize TOD deeds. In the chronological order of the statutes' enactment, the states are: Missouri (1989), Kansas (1997), Ohio (2000), New Mexico (2001), Arizona (2002), Nevada (2003), Colorado (2004), Arkansas (2005), Wisconsin (2006), and Montana (2007). Some other states, including California and Minnesota, are studying the issue. In 2006, NCCUSL agreed to draft a uniform law to implement TOD deeds and appointed a Drafting Committee. The aim of our Drafting Committee is to produce a Uniform Real Property Transfer on Death Act for states to consider for enactment. The Drafting Committee has met twice and has developed a working draft of the law, which is available for review and comment on NCCUSL's website. The current plan is to complete the drafting process within two years, hence to submit the uniform law to NCCUSL for approval in Summer 2009 and to the ABA in the year following adoption by NCCUSL.

Information and Feedback:

At the request of the ABA, the ABA Real Property and Trust Section has appointed both an ABA Section Advisor and an ABA Advisor to the Committee. As the ABA Advisor, I am tasked with disseminating information about the draft law within the ABA and obtaining feedback.

Information about the Committee's work and the full text of drafts and memoranda circulated to the Committee can be found on NCCUSL's website at www.nccusl.org/Update/CommitteeSearchResults.aspx?committee=278

Comments and suggestions on this project in progress are welcome. Please direct your comments either to me, as the ABA Advisor, at Dennis.Horn@hklaw.com or to the Reporter, Thomas P. Gallanis, Professor of Law, University of Minnesota, at gallanis@umn.edu

NEW CHANGES TO IRC RULES ON VACATION-SECOND HOMES AND 1031 EXCHANGES

By Stephen Wayner, Esq., CES
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Many tax practitioners represent clients who own vacation-second homes. These dwellings take on a variety of personas -- a beautiful home in the country, a cozy cottage on a lake, a gorgeous condominium on the ocean, or a rustic cabin in the mountains.

The exclusion of gain under Internal Revenue Code ("IRC") Section 121 does not apply to second homes because the principal residence requirements are not met. As a result, clients are not left with many options to defer taxes when they dispose of their vacation-second home assets.

However, there is one major tax strategy that comes to the rescue: a Section 1031 tax-deferred exchange.

The cloudy area for tax practitioners was how to ensure that vacation-second homes qualified under Section 1031. Recently, the IRS ("the Service") created a new formula – Rev. Proc. 2008-16. Under this formula, the dwelling unit will qualify as a "like kind property" under Section 1031. The new procedure[1] assures that the Service will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment in order to be eligible for safe harbor protection under IRC Section 1031.

In a recent conversation with J. Peter Baumgarten of the Office of Associate Chief Counsel (Income Tax & Accounting) of the Service and the author of Rev. Proc. 2008-16, we discussed many of the issues presented herein. We agreed that, as a result of the Rev. Proc., tax practitioners now have a standard that is easily identifiable for determining whether a client's dwelling unit (vacation home/second home) should qualify as an investment or property held for productive use in a trade or business under Section 1031.

For background purposes, IRC Section 1031 is known as the "Tax Deferred Exchange" provision. It provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of "like kind" that is to be held either for productive use in a trade or business or for investment (replacement property).[2]

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1 Rev. Proc. 2008-16

2 IRC Section 1031(a)

As far back as 1959, the Service concluded that gain or loss from an exchange of personal residences may not be deferred under Section 1031 because personal residences are not property held for productive use in a trade or business or for investment.[3]

In *Moore v. Commissioner*,[4] the taxpayers sold one home on a lake and tried to exchange that for another home on the same lake. Neither of these homes was ever rented or ever offered for rent. Expenses were never deducted under Section 212 for business or investment expenses. Instead, interest was deducted under Section 163 as personal home mortgage interest rather than as investment interest, and both homes were used exclusively by the taxpayers for their own personal use. The taxpayers stated that because they expected the homes to appreciate in value, the homes should then qualify under Section 1031 for a tax deferred exchange. The Tax Court disagreed and held that taxpayers with the "…mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."[5]

So, if the taxpayers could not qualify for Section 1031 tax deferral treatment because they were the only users of the property, the next issue for consideration was whether vacation homes minimally used by taxpayers could qualify under Section 1031 for tax deferral treatment. Moreover, what if the vacation/second home property was only rented out for a short period of time each year? Could that property meet the criteria of an investment and thereby qualify for Section 1031 tax deferral treatment?

Historically, Section 280A covered the issues of allowing deductions on dwelling units that taxpayers use as residences, which included vacation and second homes. This section states that a taxpayer who personally uses the dwelling unit the greater of 14 days a year or 10% of the number of days during the year for which the dwelling unit is rented at fair market value, is using the property as a "residence" and not as an "investment".[6] "Personal use" under this section of the IRC not only includes use by the taxpayer but also includes: use by any member of the taxpayer's family, or anyone who is a co-owner; use by any person utilizing the dwelling unit under an agreement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or rental of the unit by an individual for less than fair market value.[7]

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3 Rev. Rul. 59-229, 1959-2 C.B. 180

4 *Moore v. Commissioner*, T.C.Memo. 2007-134

5 *Id.*

6 IRC Section 280A(d)

7 *Tax Free Exchanges Under Section 1031(2007),* Long and Foster, Thomson/West, Pages 2-37

Most would agree with one tax analyst, who suggested it would be unwise for a taxpayer to deduct mortgage interest on a vacation home as a second home and then take the position that the property was held for investment under Section 1031. Knowing that many taxpayers hold dwelling units primarily for production of rental income, but at the same time occasionally use the property for their own personal use, the Service recently produced Rev. Proc. 2008-16 to clarify some of these issues.

Under Rev. Proc. 2008-16, the Service will not challenge whether a dwelling unit ("real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities"[8]) qualifies under Section 1031 as property held for investment or held for productive use in a trade or business, if the qualifying use meets the following standards:

(1) For the relinquished property:

- (a) the dwelling unit must be owned by the taxpayer for at least 24 months immediately before the exchange (defined as the "qualifying use period"[9]); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:
  - (i) The taxpayer must rent, at fair rent, for at least 14 days or more the dwelling unit to another person or persons, and
  - (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.[10]

(2) Similarly, for the replacement property:

- (a) The dwelling unit must be owned by the taxpayer for 24 months or more 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 must rent, at fair rent, to another person or persons for at least 14 days or more, and
  - (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.[11]

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8 Rev. Proc. 2008-16, Section 3.02

9 Rev. Proc. 2008-16, Section 4.02 (1)(a)

10 Rev. Proc. 2008-16, Section 4.02 (1)(b)

11 Rev. Proc. 2008-16, Section 4.02 (2)(b)

The Service defines "personal use of a dwelling unit" as occurring on any day that the taxpayer is deemed to have used the dwelling unit for personal purposes under Section 280A(d)(2), taking into account Section 280A(d)(3), but not Section 280A(d)(4)[12].

What is a "fair rental"? Normally a real estate practitioner would describe that term as fair market rent, but the Service uses the term "fair rental" and determines it to be based upon all of the "facts and circumstances" that exist when the rental agreement was entered into between the parties. The Service will also look at all of the rights and obligations of the parties to the rental agreement.[13]

What happens if the taxpayer files his or her federal income tax return and reports the transaction as a Section 1031 exchange, believing that the dwelling unit used as a replacement property will meet the appropriate qualifying standards, and then it is determined that this replacement property does not meet the necessary qualifying standards? The Service suggests that the taxpayer file an amended return and not report the transaction as an exchange under Section 1031.[14]

Rev. Proc. 2008-16 is limited in that it only determines whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031.[15] It does not give safe harbor protection for all of the other requirements for a "like kind" exchange under Section 1031 or under the Section 1031 regulations.[16] The effective date of Rev. Proc. 2008-16 is March 10, 2006.[17]

What happens if the taxpayer's dwelling unit does not qualify under Rev. Proc. 2008-16 for safe harbor protection? The taxpayer may still try to qualify for Section 1031 treatment, but it will have to overcome the requirements set forth in Rev. Proc 2008-16.

Following are examples that illustrate how this new Rev. Proc. works. In the first example, Taxpayer Tessie has a "second home" that she has rented out for the past five years to the same renter for the entire summer. Tessie uses the property for 10 days a year during Thanksgiving and Christmas vacations. Tessie reports the income from the rental on her income tax return and now wants to sell the property and use Section 1031 to purchase a small shopping center in her home town. Tessie's "dwelling unit" (second home) will qualify for tax deferral treatment under Section 1031 because she rented the dwelling unit for more than 14 days a year,[18] she never personally used

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12 Rev. Proc. 2008-16, Section 4.03

13 Rev. Proc. 2008-16, Section 4.04

14 Rev. Proc. 2008-16, Section 4.05

15 Rev. Proc. 2008-16, Section 4

16 *Id.*

17 Rev. Proc. 2008-16, Section 5

18 Rev. Proc. 2008-16 Section 4.02(1)(a)

the dwelling unit for more than 14 days in any one year,[19] and finally she exchanged the dwelling unit for real estate that qualifies as "like kind"[20] property.

In the second example, Taxpayer Tim has owned a mountain cabin on a lake for 20 years. Every year, Tim spent the summer fishing on the property. About five years ago he rented, at below fair rent, the dwelling unit to a fishing buddy of his for one week. He never reported the income and never tried to rent the dwelling to anyone else during the entire 20-year period he owned the cabin. Tim is now selling the cabin (dwelling unit) and wants to buy another cabin, higher on up the mountain.

According to Rev. Proc 2008-16, Tim's mountain cabin will not qualify as a dwelling unit (relinquished property) for Section 1031 purposes, because he did not have it rented at a fair rental for at least 14 days in each of the preceding 2 years prior to the transfer;[21] and he used it for more than 14 days a year or 10% of the number of days that he had the dwelling unit rented.[22] Another important problem is that Tim did not rent the unit to his friend at fair market.[23] The property Tim wants to purchase will probably not qualify as "like kind" because there is no intent to use it as an investment property or property used in a trade or business.[24]

Rev. Proc. 2008-16 would seem to clear the air on many of the foggy issues surrounding Section 1031 exchanges for vacation and second homes. That said, the taxpayer must still satisfy any and all of the other requirements for a like-kind exchange in order to qualify for tax deferred treatment.[25]

Stephen A. Wayner, Esq., C.E.S., brings over 35 years of legal and real estate experience to his position as First Vice President of Bayview 1031. Bayview 1031, a Qualified Intermediary for 1031 Tax Deferred Exchanges of Real and Personal Property, is a subsidiary of Florida-based Bayview Financial L.P., a multi-billion asset financial and real estate services company. For more information, call 866-903-1031 or visit www.bayview1031.com

19 Rev. Proc. 2008-16 Section 4.02(1)(b)

20 1031(a)

21 Rev. Proc. 2008-16 Section 4.02(1)(b)(i)

22 Rev. Proc. 2008-16 Section 4.02(1)(b)(ii)

23 Rev. Proc. 2008-16 Section 4.04

24 Section 1031(a)

25 Rev. Proc. 2008-16, Section 4.06