

SECOND HOME COURT RULING

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The Tax Court recently ruled that the sale of a vacation home and the purchase of another through an escrow agent did not qualify for tax-free like-kind exchange treatment under Sec. 1031 because the homes were not held for investment (Moore, TC Memo 2007-134). The taxpayers (P) used the homes exclusively for recreational purposes and never rented or attempted to rent out the homes to others. P's argument that he purchased the property with the expectation that the property's value would increase and he would sell the property at a profit was not enough to qualify it as property held for investment.

P purchased a second home three hours away from his principal residence. From April to September, P's family would use the property exclusively for recreational purposes two or three times a month until Labor Day (when the property would be closed until the following spring). During the off months, P would occasionally visit the property to rake leaves and perform other caretaker functions consistent with using the property as a vacation home.

P eventually moved his principal residence farther away from the vacation home. He began using the property less frequently and it became run down. P decided to purchase another vacation home closer to his new principal residence and treated the purchase and sale of the vacation homes as a tax-free like-kind exchange under Sec. 1031.

To qualify for like-kind exchange treatment under Sec. 1031:

1. Both properties exchanged must be of like kind;
2. Both properties must be held for trade, business, or investment purposes; and
3. The exchange must satisfy the procedures of a like-kind exchange under Sec. 1031(a)(3).

According to the court, the properties sold and purchased did not satisfy the wade/business/investment requirement. Neither the Code nor the regulations defines "held for investment" for purposes of Sec. 1031. The courts have ruled that the primary purpose in holding the properties must be for trade, business, or investment purposes to qualify under Sec. 1031 (Montgomery, TC Memo 1997-279) and that the investment test is applied at the time of exchange without regard to the taxpayer's motive before the exchange (see *Bolker*, 81 TC 782 (1983), *aff'd* 760 F2d 1039 (9th Cir. 1985)).

The Tax Court did not dispute P's argument that he purchased the property with the expectation that its value would appreciate. However, it held that P's primary use of the property was as a vacation home. At no point did P ever try to rent the property to third parties or have the property available for sale until he was ready to purchase a second vacation home. 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 (Jasionowski, 66 TC 312, 313 (1976)).

In addition, P stopped maintaining the first property when he no longer used it for personal purposes. The Tax Court found that this was inconsistent with an intent to maximize profit on the sale of property and demonstrated that continued maintenance was warranted only in connection with personal use. Furthermore, on P's tax return, he listed deductions for "home mortgage interest" not investment interest, nor did he deduct any depreciation, maintenance, or other expenses associated with the property. According to the Tax Court, this reporting is not consistent with holding the property for wade, business, or investment purposes.

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