IRC § 1031 Like-Kind Exchanges: Determining the Principal Use of an Asset

IRS Chief Counsel Advisory 201605017 considered the case of an *IRC § 1031* like-kind exchange of aircraft. The issues that the CCA dealt with are relevant to real estate exchanges as well.

The IRS field office found that during the year preceding an exchange of aircraft, "Y percent" of the flights taken by the relinquished aircraft were for purposes unrelated to the taxpayer's business, and "X percent" of the flights taken by the relinquished aircraft were for business or investment purposes. Although the CCA does not specify overtly, it is clear the "Y percent" is greater than 50% and "X percent" is less than 50%.

The IRS field office concluded that, because more than half of the flights taken were not for business or investment purposes, the relinquished aircraft did not qualify for *IRC § 1031* exchange treatment. The taxpayer disputed both the field office's percentage determination and conclusion.

Two legal issues were addressed in the CCA: (1) Can the aircraft be characterized essentially as two separate assets – one business/investment asset and one personal use asset – so that the business portion of the aircraft could qualify for *IRC § 1031*, although the personal use portion of the aircraft would not? (2) If the aircraft is treated as a single asset, did the field office apply the correct test to determine if the aircraft was held for productive use in trade or business or for investment?

The CCA concludes that an airplane is a single asset that is either held for productive use in trade or business or for investment, or else that is held for personal use.[1] Its use cannot be treated as if it were two separate assets. The opinion notes that the plain language of the "held for" clause of *IRC § 1031* implies that an asset either meets the test or it does not. As support for the proposition that a single asset cannot be treated in a mixed manner, the CCA cites *Rev. Proc. 2008-16*. That Revenue Procedure provides a safe harbor that the holding purpose of *IRC § 1031(a)(1)* will be considered to have been met when relinquished residential property has not been used for personal purposes more than 14 days per year or 10% of the time that it was rented at fair market rates during the 24 months prior to an exchange and when replacement property is similarly not used for personal purposes during the 24 months following an exchange. The CCA argues that if property could be

> … treated as two properties for purposes of § 1031, there would have been no need to publish Rev. Proc. 2008-16. Rather, the Service would require a deferral of the gain or loss allocable to the portion of the property that meets the "held for" requirement of § 1031 and require recognition of the gain allocable to the portion of the property used for personal purposes.

The CCA might have cited *Montgomery vs. CIR, 73 TCM 3095* (1997), affirmed in part and reversed in part on other grounds at *300 F.3d 866*:

> Furthermore, section 1031 requires that both the property transferred and the property received in a likekind [sic] exchange be held primarily for productive use in a trade or business, or for investment.

That case is cited for the same proposition in *Moore vs. CIR, TC Memo 2007-134* (2007): "It is a taxpayer's primary purpose in holding the properties that counts."

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[1] The category of property held primarily for sale (e.g., inventory) was not considered in the CCA and will be ignored for the purpose of this article.

This finding in the CCA should not be confused with *Rev. Proc. 2005-14*. That Revenue Procedure discusses two related issues. First, what to do if the taxpayer uses part of his or her primary residence for business purposes, such as a home office, a two family home or a farm with a farmhouse? In that case, the taxpayer can exchange the business portion of the property and can take the income tax exemption on the sale of a residence provided by *IRC § 121* on the residential portion of the property. Second, what to do if the taxpayer resided on the property for two of the five years prior to selling it, but moved out and converted the property into an investment property some time prior to sale? In that case, he or she should first take advantage of the *IRC § 121* deduction, and the taxpayer can also do an *IRC § 1031* like-kind exchange with the balance of the sales price.

These situations appear to be cases where a single asset is treated like two assets, part of which qualifies for like-kind exchange treatment and part of which does not. However, in first case, different physical portions of the property are primarily being used for business and personal use. That type of dual use is recognized for residences in *IRC § 280A*, which deals with deductions for home offices and the rental of a portion of a residence, where business expenses and depreciation are attributed only to the business portion of the property. In the second case, the primary holding purpose of the property changed over time. *IRC § 121* still allows a deduction for selling a *former* principal residence if the taxpayer lived there for two of the last five years. Conversion of the property to a rental does not change the taxpayer's right to claim the *IRC § 121* deduction. There are no comparable places in the tax code where an asset like an airplane is treated simultaneously in two different ways. Therefore, the general rule that an asset can have only one primary purpose applies.

The other interesting discussion in the CCA concerns the test of whether the aircraft, as a single asset, meets the "held for" requirement of *IRC § 1031(a)(1)*:

> [T]he inquiry into whether property is "held for productive use in a trade or business or for investment" is intensely factual—doubly so when the property may naturally be used for both business and personal purposes. Unfortunately, § 1031 does not provide for a simple quantitative use formula. In other words, there are no authorized absolute mechanical or quantitative tests for measuring intent and no safe harbor rules have been promulgated for these circumstances. Rather, intent must be determined by the unique facts and circumstances extant in each given transaction.

The CCA declined to give its own bright-line rule, but it did give some general guidance. It referred the matter back to the field office and instructed the field office to consider the following elements:

> (1) measurement of business/investment use versus personal use based on flight hours, not just flights; (2) percentages of business/investment use versus personal for flights and flight hours for the year before the year of the exchange; and (3) which flights and flight hours were determined to be repositioning flights and the nature of the flight following the repositioning flight.

The most significant of these factors for those of us who deal primarily with real estate transactions is the express directive for the field office to consider the *two-year* period prior to the exchange, and not simply the one-year period that the field office examined. That directive is consistent with a number of safe-harbor two-year look-back periods, especially including *Rev. Proc. 2008-16*, discussed above. The CCA is an indication that the two-year lookback period is not simply a convenient standard for safeharbors, but rather an emerging audit policy. Ultimately, the test continues to be whether "…over 50 percent of the use of the aircraft was for personal purposes…." Now we can answer with a little more clarity the question, "For how long?"