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## **Qualify your investment (second home) property as an IRC Section 1031 exchange**

January 23, 2008 - Spotlights

We are consulted daily about how to make a vacation property qualify as an Internal Revenue Code (IRC) Section 1031 Exchange. This is a troublesome area, however, with careful planning and patience, the capital gain tax can be deferred, indefinitely.

Some exchange companies have been handling these exchanges without questioning the personal use limitations; this is a mistake! The United States Tax Court issued Tax Court Memo 2007-134 on May 30, 2007 in the case of Barry and Deborah E. Moore v. Commissioner. The case makes it clear that second homes are NOT exchangeable.

A recent situation will help illustrate how this CAN be accomplished. Our client owns a slope side townhouse at a New England ski resort that he and his family have used for weekends and vacations for the past ten years. During that time, the property has experienced significant market appreciation and the client is facing a 15% federal capital gain tax as well as a state capital gain tax of 8%. On a gain of \$300,000, (sale \$450,000 less original cost of \$120,000 and selling expenses of \$30,000) the tax bill will be \$69,000, ouch! The best way to avoid this situation is to convert the property from personal use to a commercial rental for at least two tax years, the longer the better, and later sell it using a Section 1031 Exchange. He immediately signs a rental agreement with a local property manager and informs his accountant that he is making a change in use of the property.

Now, roll the calendar ahead by two years, he is ready to sell the ski property and enter into an Exchange Agreement with a Qualified Intermediary (QI). He is anticipating acquiring Replacement Property that will further benefit the family. In order for him to get a good exchange (one where no tax is due) he will need to purchase new property of an equal or greater value of the property he sells. His two high school aged children have decided to attend an out of state college and he is contemplating acquiring a four-family residence in the college community at a cost of \$560,000. His plan is for the children to reside in one unit while they attend college and rent the remaining three units to other students. Three-quarters of the new property (\$420,000) will be used for investment purposes and he will lower his tuition bill by providing off campus housing. Note that since his children will not be paying market rent, he needs to provide \$140,000 of the purchase price personally (cash or bank loan). He plans to own this new property for the next four to six years and will exchange again for property in a sunshine state.

He engages us as his QI once he has a purchase and sale agreement on the ski property. An Exchange Agreement is created and signed by the QI and the client. Instructions are then sent to the settlement agent representing the buyer of the ski property. At closing, the funds are made payable to the QI and held in escrow pending the election of the Replacement Property in the designated college town. By regulation, a list of potential Replacement Properties must be identified

in writing within 45 days of the sale of the ski property and the acquisitions must be completed within 180 days. Once again, the family gets a great benefit without the loss of equity that has been accumulated in the investment property to capital gains tax. It is clear that careful planning produces great results!

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