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Selling or buying vacation property? Guidelines for utilizing IRC Section 1031

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As the summer months begin to wane into autumn, there are still several more "good weather" weekends to be enjoyed near the lakes and along the seacoast areas of New England. Then before long, vacationers will be heading our way to view the fall foliage and on to skiing down some of the many slopes in the mountainous regions. Current "vacation property" owners in these New England locations may be contemplating the sale of some or all of their rental properties, while others interested in investing in these beautiful areas may be considering a "vacation property" purchase. In either case, it is important for taxpayers to be aware of the guidelines issued by the IRS as it pertains to the categorization of a "vacation property" when planning for either a sale or a purchase of this type, should the taxpayer wish to utilize IRC Section 1031 as part of a tax-savings, wealth building investment strategy.

Revenue Procedure 2008-16 (the "Procedure") creates a safe harbor definition of investment property applicable to exchange transactions which closed after March 10, 2008 that involve the transfer of property consisting of a dwelling unit (defined below) and/or the acquisition of a dwelling unit as replacement property. In short, the IRS will not challenge whether a residential property or vacation home property is held for productive use in a trade or business or for investment if certain specified ownership and use requirements are met. This safe harbor Procedure provides useful guidance on the characterization of vacation property and may also be useful for planning purposes such as the conversion of a principal residence into a qualifying relinquished property.

Requirements of Revenue

Procedure 2008-16

A dwelling unit is defined as any real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including a sleeping space, bathroom and cooking facilities (e.g., a residential property).

The IRS will not challenge whether a dwelling unit qualifies as a §1031 exchange property held for productive use in a trade or business or for investment if: (1) the relinquished property is owned by the taxpayer for at least 24 months immediately prior to the exchange and a replacement property is owned for at least 24 months immediately after the exchange (the "qualifying use period") and (2) within each of the two 12 month periods constituting the qualifying use period, the taxpayer must:

- a) Rent the property to another person or persons at a fair rental for 14 or more days; and
- b) The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the number of days during the 12-month period the dwelling unit is rented at a fair rental.

Under the procedure, personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes under §280A(d)(2) (taking into account §280A(d)(3) but not §280A(d)(4)). Thus, personal use includes: (1) use by the taxpayer or any

other person who has an interest in the property or by a family member; (2) use by any individual who uses the unit under an arrangement 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 (3) use by any other individual if rented for less than fair market value. A taxpayer can rent the property to a family member if the family member uses the property as a primary residence and the family member pays fair market rent. Whether a dwelling unit is rented at a fair rental is determined based on all the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

Safe Harbor, but Not

a "Brightline" Test

The procedure provides a safe harbor for purposes of characterizing investment property for purposes of Internal Revenue Code Â§1031. Property that does not meet the terms of the safe harbor may nevertheless constitute qualifying relinquished or replacement property under current law. Of course, any exchange must meet all other applicable legal requirements. Every taxpayer should consult with their legal and tax advisor before engaging in any Â§1031 exchange.

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