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Your vacation home may qualify for a like-kind exchange

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Under §1031 of the Internal Revenue Code, gain derived from the sale of property used in a trade or business or held for investment can be deferred if exchanged for like-kind property. Personal dwellings generally do not qualify, as taxpayers cannot establish an investment intent merely because of the expectation that the property will appreciate. In recently issued Revenue Procedure 2008-16 the IRS assented to the notion that some personal use of a rental property will not disqualify the sale of the property from the §1031 deferral. The IRS recognizes that taxpayers frequently hold vacation homes primarily for rental, but occasionally make use of the dwelling for personal purposes by providing a safe harbor under which the IRS will not challenge whether a rental dwelling that is also used for personal purposes qualifies under §1031.

To qualify, your dwelling must be owned for at least 24 months immediately before the exchange, and in each of the 12-month periods preceding the exchange, (a) you must rent the dwelling at fair rental for at least 14 days, and (b) your personal use of the dwelling cannot exceed the greater of 14 days or 10% of the number of days the dwelling is rented during the 12-month period. So, if your house on the Cape is rented for the month of July, you could only use the house for 14 days without disqualifying the property. Personal use occurs if you use the property or are deemed to use the property (as would be the case if your family members use your Cape house). Similar rules apply to determine whether the new dwelling acquired qualifies as a §1031 replacement property based on your expected use of the dwelling during the 24-month period following the exchange. If you report a transaction as a §1031 exchange based on your expectation that the acquired dwelling would satisfy the safe harbor, and subsequently you determine that it does not, then the Revenue Procedure provides that an amended return should be filed.

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