

Tax Alert 2008-04

IRS clarifies when a vacation home can be part of a like-kind exchange

The IRS has just released Revenue Procedure 2008-16, which sets out a “safe harbor” test. If you meet the requirement of this test, then your vacation home can be eligible to be part of a “like-kind exchange” for federal income tax purposes.

OVERVIEW

Investment real estate can be exchanged for other investment real estate, as part of a “like-kind exchange,”¹ which either wholly or partially defers any gain on the sale of the property you own, if certain statutory requirements are met². This favorable income tax treatment is not available for the sale or exchange of your personal residence.³

If you own a vacation residence that is rented some of the time, it raises a long-standing point of uncertainty – is your vacation home more properly characterized as (i) investment (rental) property, which is eligible to be part of a like-kind exchange, or (ii) a personal residence, which is not eligible to be part of a like-kind exchange.

The IRS recently released Revenue Procedure 2008-16 establishing a “safe harbor” test – if you meet the requirements of the test, then your vacation home can qualify for favorable like-kind exchange treatment.

THE SAFE HARBOR TEST

In order to meet the IRS safe harbor, the property you currently own and plan to transfer (the “relinquished property”) and the property you subsequently acquire (the “replacement property”) must both satisfy the following requirements.

- You must own the relinquished property for 24 months before the exchange; you must own the replacement property for 24 months after the exchange;⁴
- You must rent each of the relinquished and replacement properties to someone⁵ for fair rental value for at least 14 days in each of the two 12-month periods before and after the like-kind exchange;
- In each of the two 12-month periods before and after the like-kind exchange, your personal use⁶ of the property cannot exceed the greater of (i) 14 days or (ii) 10% of the rental days. The following table summarizes the maximum number of days you could use the property personally, depending on the number of days it is rented.

If your vacation home is rented this many days during the year then you must use it personally no more than this many days.
14	14
30	14
50	14
100	14
150	15
200	20
250	25

¹ “Like-kind exchanges” are governed under §1031 of the Internal Revenue Code; thus, they are sometimes also referred to as “Section 1031 Exchanges”.

² Real estate that is used in a trade or business can also qualify. This Alert, however, will focus only on rental investment real estate: in particular, a vacation home.

³ However, in certain circumstances, you will be able to exclude up to \$250,000 of capital gain (up to \$500,000 for married couples filing jointly) on the sale of your personal residence that you use as your “principal” residence.

⁴ If you initially report the transaction as tax-free but subsequently fail to meet all the requirements, you might have to file an amended return to report the gain.

⁵ Renting to family members (brother, sister, half-brother or half-sister, spouse, ancestor or lineal descendant) will be considered personal use, not rental, unless it is for full rental value and is the family member’s principal residence.

⁶ Your “personal use” would generally mean use by you and or family members.

WHAT IS A “SAFE HARBOR”?

This IRS test is a “safe harbor.” That means if you meet this test, then the IRS will not challenge the transaction as qualifying for favorable like-kind exchange treatment. This does not mean that if you fail this test, then you automatically do not qualify for the like-kind exchange. Rather, failing these tests means only that you do not fall within the safe harbor. It is possible to fall “outside” the safe harbor but nevertheless qualify for the favorable like-kind exchange treatment.

PLANNING OPPORTUNITIES

This IRS announcement offers some planning opportunities if you own a vacation home that you might sell within the next few years. Here are two examples.

Example #1

Assume you own a vacation home in a year-round resort, purchased years ago for \$250,000 and now worth \$1,000,000. You have been using it 5 weeks out of the year for family vacations; for the other 47 weeks of the year you rent it out via a property management firm. You are thinking of selling in a few years.

Under these facts, you would not fall within the IRS safe harbor. If you rent your vacation home 47 weeks of the year (329 days), then you can use it personally no more than the greater of (i) 14 days or (ii) 10% of the rental days. In other words, you can use it personally no more than 32 days. This example assumes you use it personally 35 days each year.

Solution -- decrease personal use: If you decreased your use of the vacation home to 4 weeks for each the two 12-month periods preceding your sale (renting it the other 48 weeks), that would indeed satisfy the safe harbor test. Assuming you meet the other requirements, you could engage in a like-kind exchange that could allow you to “sell” your vacation home for \$1,000,000 and purchase another vacation home

for at least \$1,000,000, without triggering federal income tax.

Example #2

Assume you inherited a vacation home years ago. Its value then was \$250,000 but is now worth \$1,000,000. You have been using it 2 weeks each year during the kids’ school vacations, but now the kids are grown and you are considering selling it to buy a new vacation home.

Under these facts, you would not fall within the IRS safe harbor. You have never rented your vacation home.

Solution -- increase rental use: If you were to rent it out for 14 days for each of the two 12- month periods preceding your sale (continuing to use it yourself 2 weeks), that would satisfy the safe harbor test. Assuming you meet the other requirements, you could engage in a like-kind exchange that could allow you to “sell” your vacation home for \$1,000,000 and purchase another vacation home for at least \$1,000,000, without triggering federal income tax.

CAUTION: STATE LAW IMPLICATIONS

The safe harbor rules set forth in this Alert summarize “federal” income tax laws. As a note of caution: if you own property in a state that has an income tax, the favorable “like-kind” exchange rules might apply only if you purchase the replacement property in that same state. As a corollary, if the replacement property is purchased in another state, the sale of the relinquished property might trigger state income taxes (even if it does not trigger federal income tax).

LIKE KIND EXCHANGE RULES

This Alert has summarized only the issue of whether your vacation home can qualify as investment property for purposes of the like-kind exchange rules. There are many other requirements of a like-kind exchange that have not been discussed. We have a separate summary of those requirements, which we are happy to share with you upon request.

National Wealth Planning Strategies Group

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