

Exchanging vacation homes is easier

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Many investors are taking advantage of the like-kind exchange, which is authorized under Section 1031 of the Internal Revenue Code. These exchanges are commonly referred to as "Starker" exchanges, after T.J. Starker, the man who challenged the Internal Revenue Service and won.

But if you own a vacation home, there has been a lot of confusion as to whether that property qualifies for the exchange.

Indeed, back in September 2007, the Treasury Inspector General for Tax Administration (TIGTA) issued a scathing report about the lack of IRS oversight of the capital gains (or losses) deferred through this kind of exchange.

The TIGTA report recommended that the IRS "must provide clear guidance to taxpayers regarding the rules and regulations governing like-kind exchanges with respect to second and vacation homes that were not used exclusively by owners."

The inspector general expressed concerns that "the absence of clarification on this issue leaves un rebutted the sales pitch of like-kind exchange promoters who may encourage taxpayers to improperly claim deferral of capital gains tax by selling non-qualified second and vacation homes through 'tax-free' exchanges."

The IRS agreed and promised to issue guidelines by March 15, 2008.

True to its word, effective March 10, 2008, we now have what is known as a "safe harbor" for these vacation-home exchanges.

In order to have a valid Starker exchange, only investment properties can be swapped with other investment properties. There are other tax benefits for homes used as the principal residence, such as the ability to shelter up to \$500,000 of the profit you have made (if you are single or file a separate tax return, this exclusion is limited to \$250,000 of gain.)

According to Revenue Procedure 2008-16, the property must be a house, apartment, condominium or similar improvement that "provides basic living accommodations, including sleeping space, bathroom and cooking facilities." This can include mobile homes and boats.

When discussing the 1031 exchange, one must use the proper terminology. The property that you currently own and want to dispose of is called the "relinquished property." The new property that you want to obtain by way of the exchange is the "replacement property."

A safe harbor simply means that if you follow the guidelines promulgated by the IRS, your tax return will not be challenged.

To qualify the relinquished vacation or second home for the exchange, it must have been owned by the taxpayer for at least 24 months immediately before the exchange. (The IRS refers to this as the "qualifying use period.")

And in addition, for each of the two years within the qualifying use period, the taxpayer must have rented the property at a fair rental for at least 14 days. Furthermore, the taxpayer cannot have used it personally for the greater of 14 days or 10 percent of the number of days during each 12-month period that the property is rented at a fair rental.

Sounds confusing, but it is the law. The IRS does not want taxpayers to claim that their property is "investment" when in fact they take their families to the beach for the entire summer.

You can, of course, periodically go to your second home

to inspect it, and make any necessary repairs. However, if that use exceeds the use restrictions described above, you will not be able to do a Starker exchange. Confirm this with your own accountant.

What is fair rental? The IRS falls back on its standard formula: It will look to the facts and circumstances of each case. To be on the safe side, have at least two real estate agents provide you with a written market analysis of the rents being charged for similar properties in the area where both the relinquished and the replacement properties are located.

What about the replacement property? Here, the same rules apply. If you swap one property for another, you must rent it out for at least two years or the exchange will fail. According to the IRS:

"If a taxpayer files a federal income tax return and reports

a transaction as an exchange under §1031, based on the expectation that a dwelling unit will meet the qualifying use standards . . . and subsequently determines that the dwelling unit does not meet (those) standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange . . ."

That could be calamitous. You did a 1031 exchange, and by law, you have to use all of the proceeds from the sale of the relinquished property in order to obtain the replacement property. Now, you have failed to comply with the requirements and have to file an amended return — and pay the tax on the capital gain. Where will you get the money to do this?

If you follow the rules, a 1031 exchange is a very valuable tool. For example, if you purchased your investment prop-

erty for \$200,000 and sold it for \$400,000, you would in most cases have to pay the IRS \$30,000, in addition to any state or local tax. However, if this property were sold in connection with a Starker exchange, and you obtained another investment property worth at least \$400,000, you would not have to pay any capital-gains tax. Instead, the basis of the old property would be transferred to the new one; you would have to pay the tax only when you ultimately sold the replacement property and did not engage in yet another 1031 exchange.

But you must understand that a 1031 is not a "tax free" process; it simply defers the time when you have to pay the capital-gains tax.

The rules

And even if you follow the vacation rules outlined in the

recent Revenue Procedure, you still have to comply with the general requirements of a like-kind exchange. While you must consult your tax and legal advisors about your specific situation, here is a brief synopsis of the rules:

■ You must identify the replacement property within 45 days after you have gone to settlement on the relinquished property. The identification must be as specific as possible. You can identify up to three such replacement properties. However, if you want to identify more, the aggregate fair-market value of the identified properties cannot exceed 200 percent of the aggregate value of the relinquished property (or properties).

■ The price of the replacement property must be at least equal to the sales price of the relinquished property. All of the sales proceeds from the relin-

quished property must be held in escrow by a qualified intermediary; under no circumstances can you have any access to that money. It must all go into the purchase of the replacement property.

■ And finally, you must acquire the new property within 180 days from the day you disposed of the relinquished property.

The rules are complex, and must be followed religiously. A successful 1031 "Starker" exchange is a valuable tool for investors, but any misstep will cause you to have to pay the capital gains tax that you are trying to defer.

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