



2008 IRS 1031 EXCHANGE RULINGS AND CHANGES

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The I.R.S. provided two major rulings for 1031 tax deferred exchanges through Revenue Procedure 2008-16 and the Housing Assistance Tax Act of 2008. If you are converting a rental property into a primary residence or are considering a 1031 Exchange for vacation property these new rulings will affect you.

Exclusion Limitations when converting Rental, Second Home or 1031 Exchange Property into a Primary Residence:

In order to utilize the primary resident exclusion on a converted rental house, the taxpayer is now required to own the new rental property for five years (Rev. Proc. 2005-14), rent the exchange property for a minimum of two years (Rev. Proc. 2008-16) and live in it for a minimum of two years as their principal residence (IRS Section 121).

Currently, a taxpayer can exclude up to \$250,000 of gain realized on the sale of a primary residence (\$500,000 for couples filing jointly) if they have owned and occupied the residence for two years during the five year period preceding the date of the sale. Additionally, the Housing Assistance Act of 2008 limits the Primary Residence Exclusion for periods of "nonqualified use":

Effective January 1, 2009 the primary residence exclusion will not apply to the gain from the sale of the converted primary residence that is allocable to periods of "nonqualified use". Nonqualified use refers to periods that the property is not used as the taxpayer's principal residence. When a rental property or second home is converted into a primary residence, it would be considered as nonqualified use prior to the conversion.

Additionally, any nonqualified use prior to January 1, 2009 is not taken into account in the allocation between nonqualified and qualified use.

Gain related to depreciation deductions taken on the property since May 6, 1997 is not eligible for exclusion. Currently, the depreciation recapture is taxed at a 25% rate.

Vacation Property Exchange Guidelines:

The IRS Revenue Procedure 2008-16 provides specific guidelines for a safe harbor vacation property 1031 exchange. To meet the IRS requirements, a taxpayer, during 2 years prior to the sale of their vacation home or 2 years after the purchase of their vacation property as a 1031 replacement property must:

1. Rent the property at fair market rent for a minimum of 14 days during each 12 month term of the 2 year period.
2. Limit personal use of the property during each 12 month period of the 2 year period not to exceed the greater of: 14 days or 10 percent of the number of days the property is rented at a fair market rent during each of the two 12 month periods.

Personal use includes use by any member of the family of the taxpayer unless the vacation property is rented out as a primary residence at a fair market rent. Use by any other individual if rented for less than fair market rent is also not allowed. Maintenance days will not count towards the 14 of personal use days. In summary, a taxpayer can either buy or take an existing vacation home and rent it at fair market value for 14 days per year for two years and then exchange out of it. Remember that personal use must be limited during these two years – maximum of 14 days during each 12 month period before or after the exchange into vacation property. The taxpayer should have a rental agreement and report the income, expense and depreciation on Schedule E of their tax return.

The new 1031 requirements for vacation property exchanges and the exclusion limitations for converted rental property into a primary residence are very complicated. Taxpayers are advised to check with their direct tax advisor prior to any vacation property 1031 exchange activity or conversion to a primary residence.



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