



Exchange News

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Does Your Vacation Home Qualify for a 1031 Exchange?

Recent articles in the national press have continued to raise the issue of whether your rented vacation home qualifies for a tax-deferred 1031 exchange. The IRS failure to address the issue and provide specific guidance leaves many rental vacation property homeowners in a quandary.

The controversial part of this issue occurs when personal use exceeds the limitations of IRC Section 280A, but the property is rented for part of the year. If the personal use limitations are exceeded, then the property is not considered as being held for business but could qualify as an investment property. Many practitioners maintain that Section 280A does not determine if the property can qualify for a like-kind exchange. What Section 280A does is establish specific rules on what annual tax deductions can be taken if personal use exceeds the established limits. Basically, annual rental expense deductions cannot exceed gross rental income. If the taxpayer wishing to do an exchange has personally used a second home in excess of the 14 day or 10% of days actually rented Section 280A criteria, they need to recognize that the IRS may review the facts to determine if the taxpayer had a primary profit and investment motive.

Since personal use has such a broad definition, it is easy to exceed the Section 280A restriction. Personal use is defined as any day the unit is used by (1) you or any person who has an interest in the property, unless you rent it to another owner as their principal home under a shared equity financing agreement; (2) a member of your family or a member of a co-owners family; (3) anyone under an arrangement that lets you use some other dwelling unit; and (4) anyone at less than a fair rental price (see Page 6 of IRS Publication 527 for details, available online at www.irs.gov/pub/irs-pdf/p527.pdf).

While most conservative tax advisors have stated that if personal use of a vacation property exceeds 14 days or 10% of the days actually rented, whichever is greater, than the property does not qualify for a 1031 like-kind exchange, others claim that additional personal use only moves the property out of the business category, but that it still qualifies as an investment property. For the peace of mind of both taxpayers and their advisors, the IRS needs to resolve this issue by providing definitive guidance as soon as possible.

For full coverage of this issue, go to www.1031.us and select the article, *1031 Qualification for Vacation Homes*, by Ed Horan, CES®, at the top of the page.

Undivided Fractional Interest in Rental Real Estate

The IRS has reaffirmed in PLR 200625009 that an undivided interest in real property may qualify as being eligible as IRC 1031 replacement property. For real estate investors wanting to maintain their tenants-in-common (TIC) interest in a property as a separate entity and not be considered an interest in a business entity under IRS regulations section 301.7701-2(a), this private letter ruling (PLR) provides some excellent guidance. The two co-owners who requested the ruling had constructed a well written TIC agreement, including a buy-sell document. The IRS measured the co-owners arrangement against all the necessary conditions set forth in Revenue Procedure 2002-22, entitled *Tenants-in-Common*, and published in April 2002. The revenue procedure specifies the conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity. Links to these documents are available through our web site, www.1031.us, by clicking on the electronic version of this newsletter at the top of the page, or view them at www.irs.gov/pub/irs-wd/0625009.pdf for PLR 200625009, and www.irs.gov/pub/irs-drop/rp-02-22.pdf for Revenue Procedure 2002-22.

Mailing Address Reminder

Our new mailing address and physical location is 14540 John Marshall Highway, Suite 207, Gainesville, VA 20155. There has been no change to our telephone or fax numbers.

Shared Equity Financing Agreement

Recently, a nationally syndicated real estate columnist was asked, "If we sell our rental property, can we avoid capital gains if we help our daughter purchase a place to live?" The answer was – Tough break, you will have to pay the capital gains tax when you sell your rental. This, of course, is not a complete answer. Mom and Pop can do a 1031 like-kind exchange and purchase, with their daughter, an interest in her new home.

However, this type of exchange and purchase requires a **shared equity financing agreement**. This agreement is required by the IRS because the personal use of a home by a co-owner (see definition of personal use in "Does Your Vacation Home Qualify for a 1031 Exchange" article on page one) may disqualify the property as an investment property unless there is a "shared equity financing agreement." If the exchangor plans to purchase with a co-owner a replacement property in which the co-owner will live, it is essential that they have such a written agreement. Without this agreement, the IRS will treat the property as a personal use second home. As such, it may not qualify as a rental or an exchange replacement property. Most real estate professionals are not familiar with this requirement and few attorneys have experience preparing such an agreement. Thus, if you are planning to co-own your investment property with an occupant, we strongly recommend you obtain guidance from nationally recognized Attorney Marilyn D. Sullivan. For her help go to www.msullivan.com/products/index.html.

Email Distribution of Exchange News

For those of you currently receiving this newsletter by regular mail, we encourage you to consider e-mail receipt in the future. This includes Special Email Editions and Tax Alerts for new changes to IRC 1031 rules and procedures as they occur. Just visit our web site, www.1031.us, and at the top of the home page, click on the "Newsletter Sign Up" button where you will be able to give us your e-mail address.

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Email Bill or Cindy directly from our website: www.1031.us/ContactUs/

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