



Selling your Hamptons beach house in a §1031 Exchange - by Pamela Michaels

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2020 and 2021 are proving to be the best years in a decade for residential real estate sales, particularly in resort, rural, beach front areas and the Hamptons. So it's no surprise that many owners faced with a windfall gain turn to Section 1031 in order to defer their capital gain taxes. However before signing a contract for the sale of a part time or vacation home, its critical to understand whether the sale will qualify for deferral under §1031. This article explains the requirements that must be met to qualify such properties for a §1031 exchange.

The requirements are set forth in Revenue Procedure 2008-16. The procedure created a safe harbor definition of investment property applicable to IRC Section 1031 exchange transactions closing after March 10th, 2008, that involve the transfer of property consisting of a dwelling unit (defined below) and/or the acquisition of a dwelling unit as replacement property. In short, the IRS will not challenge whether a residential property or vacation home property is held for productive use in a trade or business or for investment if certain specified ownership and use requirements are met. This safe harbor Procedure provides useful guidance on the characterization of vacation property and may also be useful for planning purposes such as the conversion of a principal residence into a qualifying relinquished property. It is important to note that any property used exclusively for personal enjoyment will not qualify for a §1031 exchange.

Requirements of Revenue Procedure 2008-16

A dwelling unit is defined as any real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including a sleeping space, bathroom and cooking facilities (e.g., a residential property). The IRS will not challenge whether a dwelling unit qualifies as §1031 exchange like-kind property held for productive use in a trade or business or for investment if:

1. The relinquished property is owned by the taxpayer for at least 24 months immediately prior to the 1031 exchange and a replacement property is owned for at least 24 months immediately after the 1031 exchange (the "qualifying use period"), and,
2. Within each of the two 12-month periods constituting the qualifying use period, (a) the taxpayer has rented the property to another person or persons at a fair market rent for 14 or more days; and,

(b) The taxpayer's personal use of the dwelling unit has not exceeded the greater of 14 days or 10% of the number of days during the 12-month period the dwelling unit is rented at a fair market rent. Under the Procedure, personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes under §280A(d)(2) (taking into account §280A(d)(3) but not §280A(d)(4)). Thus, personal use includes:

1. Use by the taxpayer or any other person who has an interest in the property or by a family member;
2. Use by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or
3. Use by any other individual if rented for less than fair market value.

Note that a taxpayer can rent the property to a family member if the family member pays fair market rent under an arms length written lease. Whether a dwelling unit is rented at a fair market rental rate is determined based on all the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account. The Procedure provides a safe harbor for purposes of characterizing investment property for purposes of IRC §1031. Of course, any qualifying 1031 exchange must meet all other applicable legal requirements of §1031. Every taxpayer should consult with their legal and tax advisor before engaging in any 1031 exchange to review their unique facts and circumstances.

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