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SAFE HARBOR FOR RENT

By Jerrold J. Stern

Many taxpayers who own rental units occasionally use the properties for personal purposes. Thankfully, the IRS has announced that "in the interest of sound tax administration," limited personal use will not prevent a rental "dwelling unit" from qualifying for tax-free like-kind exchange treatment (see Revenue Procedure 2008-16).

A dwelling unit is defined as real property improved with a house, apartment, condominium or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.

To qualify for this safe harbor, both the relinquished property and the replacement property must meet certain requirements.

Relinquished Property

The dwelling unit to be traded must be owned by the taxpayer for at least 24 months immediately *before* the exchange (the "qualifying use period"). Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange, (a) the taxpayer must rent the dwelling unit to another person or persons at a fair market rental for 14 days or more, and (b) the taxpayer's personal use of the dwelling unit must not exceed the greater of 14 days or 10 percent of the number of rental days during the 12-month period.

Replacement Property

The replacement dwelling unit must be owned by the taxpayer for at least 24 months immediately *after* the exchange (also called the "qualifying use period"). Within this qualifying use period, in each of the two 12-month periods immediately after the exchange, (a) the taxpayer must rent the dwelling unit to another person or persons at a fair market rental for 14 days or more, and (b) the taxpayer's personal use of the dwelling unit may not exceed the greater of 14 days or 10 percent of the number of rental days during the 12-month period.

Personal Use Explained

"Personal use" occurs if the unit is used for personal purposes by the taxpayer or any other person who has an interest in the unit (such as a partner who co-owns the property). Personal use also includes use (a) by any member of the family of the taxpayer, or (b) by any individual under an arrangement that enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit).

Brenda and Eddie are married and file a joint tax return. In 2004, they purchased a vacation cottage in Galveston. Their property manager rents to unrelated individuals and families 200 days per year. Brenda and Eddie use the cottage for vacation during the first 17 days of June each year.

On May 1, 2008, a broker who specializes in like-kind exchanges helps the couple exchange the Galveston cottage for a similar property in Corpus Christi. The Corpus Christi property will be used in the same manner. The properties have equal fair market values and are owned free and clear (without mortgages).

This exchange meets the tax-free like-kind exchange requirements. The Galveston property was owned and rented the requisite amount of time before the exchange. Brenda and Eddie's personal use of the property each year satisfies the requirement that it be less than the greater of 14 days *or* 10 percent of the rental days (17 days is less than 20 days [10 percent of 200 rental days]).

The new safe harbor rules apply only to transactions occurring on or after March 10, 2008. Taxpayers who have like-kind exchange transactions must file Form 8824 with their tax returns.

If, in a subsequent year, the taxpayer fails to meet the replacement property rules (that is, sells the replacement property within 24 months of acquisition), an amended tax return must be filed. To qualify for safe harbor treatment, the transactions must satisfy all of the regular requirements for like-kind exchanges.

Like-kind exchanges offer excellent tax-savings opportunities, even for properties with limited personal use. Consultation with a tax accountant or tax attorney is recommended.

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THE TAKEAWAY

Thanks to a new IRS rule, limited personal use will not prevent a rental home from qualifying for tax-free like-kind exchange treatment.

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