

EXCHANGE SAFE HARBOR FOR CONVERTING A RENTAL PROPERTY INTO A PRIMARY HOME, SECOND HOME, OR VACATION HOME AND SAFE HARBOR FOR CONVERTING A PRIMARY HOME INTO A RENTAL PROPERTY AND SECTION 121 GAIN EXCLUSION

I. We finally have a bright line test for converting a rental into a primary home, secondary home or vacation property.

Revenue Procedure 2008-16 offers this safe harbor for exchanges taking place after March 10, 2008.

Why is this important?

Often an Exchangor will want to buy a primary home, second home, or vacation home as part of an exchange. Now there is a safe harbor to achieve that goal! The sting of a high priced new property may be lessened because you can ultimately use the property as your new home or vacation home.

What does the Safe Harbor require to achieve the goal of converting an investment property into a primary home, second home, or vacation home?

The Investment Property being sold has to be owned by the Exchangor for at least 24 months prior to sale and must be held for investment purposes during that period (which means the Exchangor can not violate the fair market rental and personal use tests described below).

The new Property purchased by the Exchangor has to be used as an investment property for at least 24 months after the purchase. Also, for each of the two 12 month periods immediately after the exchange:

- A. The property must be rented to another person at fair market rental for 14 days or more a year ("fair market rental test"); and
- B. The Exchangor's personal use of the property must not exceed the greater of 14 days or 10% of the time the property is rented out at fair market rent during that 12 month period ("personal use test").

What constitutes personal use by the Exchangor which could disqualify the exchange?

- A. Use of the property by Exchangor, Property Co-Owner, or members of the Exchangor's family. But, if the family members are renting the



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property as their primary residence at fair market rent, family members' use will not be treated as personal use;

- B. Use of the property by someone with whom you have a time swap arrangement; and
- C. Use of the property by anyone paying less than fair market rent.

Use by the Exchangor for Repair and Maintenance:

Time spent by the Exchangor on the property for repairs and maintenance does not count as personal use by the Exchangor. But watch out! The standards for the time spent on maintenance and repair under Regulation 1.280A (d) (2) (4) are very strict. The Exchangor has to work on maintenance and repairs the lesser of 8 hours or 2/3rds of the time the Exchangor is on the premises.

Conversion to Personal Use/Section 121 Gain Exclusion

After holding the Replacement Property for 2 years and not violating the fair market rental and personal use tests described above, the Replacement Property can be converted into a primary home, secondary home or vacation property. When you ultimately sell the replacement property you have converted into a residence, you may be able to exclude all or a portion of the gain on the sale provided you have owned the property for at least 5 years.

New amendments to Section 121 do not allow you to exclude gain on the sale allocated to periods of "non-qualified" (rental) use. Under the new law, if you acquire a replacement property on or after January 1, 2009, rent it for 2 years, live in it for 3 years, and then sell it for a \$300,000.00 profit, 40% of the gain realized (2 years of non-qualified use divided by 5 years of ownership) or \$120,000.00 is not eligible for exclusion and 60% of the gain (3 years of use as a residence divided by 5 years of ownership) or \$180,000.00 is eligible (but you can never exclude gain in excess of the \$250,000.00 and \$500,000.00 exclusion limits).

Periods of non-qualified use prior to January 1, 2009 are not taken into account in making the allocation. So, if you bought a replacement property on January 1, 2007, rented it for 2 years until January 1, 2009, then moved into it for 3 years and sold it, all of the gain (up to the exclusion limits) would be eligible for exclusion. If property was bought on January 1, 2007, rented for 3 years to January 1, 2010, and then moved into for 3 years until January 1, 2013, only the 2009 rental use is non-qualified. In this example, 1/6th of the gain realized (1 year of non-qualified use divided by 6 years of ownership) is not eligible for exclusion and 5/6th is (up to the exclusion limits). These rules are very complicated and prior to converting your rental property you have exchanged for into a residence, it is important you consult with your tax advisor.



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II. We finally have a bright line test for converting a primary home into a rental property.

Revenue Procedure 2008-16 offers this safe harbor for exchanges taking place after March 10, 2008.

Why is this important?

Often an Exchangor will have “too much” gain on the sale of a personal residence to be sheltered under Code Section 121. The “too much gain” would be any gain over \$250,000 for a single owner or \$500,000 for a married couple.

Now there is a safe harbor to shelter the “too much” gain portion of the residence sale from capital gains tax by converting the personal residence into an investment property, and holding it as an investment for at least 24 months immediately prior to sale.

What does the Safe Harbor require to achieve the goal of converting a primary residence into an investment property?

The Residence being converted to an investment has to be used for investment purposes by the Exchangor for at least 24 months immediately prior to the sale. In addition to remain eligible for the 121 capital gain exclusion, the property has to have been used as the Exchangor’s personal residence for 24 months out of the last 60 months at the time of the sale.

In each of the two 12 month periods immediately prior to the sale of the property:

- A. The property is rented to another person at fair market rental for 14 days or more a year; and
- B. The Exchangor’s personal use of the property does not exceed the greater of 14 days or 10% of the time the property is rented out at fair market rent during that 12 month period.

What constitutes personal use by the Exchangor which could disqualify the exchange?

- A. Use of the property by Exchangor, property co-owner or members of the Exchangor’s family. But, if the family members are renting the property as their primary residence at fair market rent, family members’ use will not be treated as personal use.
- B. Use of the property by someone with whom you have a time swap arrangement.
- C. Use of the property by anyone paying less than fair market rent.



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Use by the Exchangor for Repair and Maintenance:

Time spent by the Exchangor on the property for repairs and maintenance do not count as personal use by the Exchangor. But see the rules, spelled out above, about work time requirements.

Conversion to Investment Use/Section 121 Gain Exclusion

At the end of the 24 month rental period, the residence (now investment property) could be exchanged for another investment property. The first \$250,000 of proceeds for a single person or \$500,000 of proceeds for a married couple could be pulled out with no tax bite (except for the depreciation recapture for the 2 year rental period) because of the Code Section 121 exclusions. The 1031 exchange could defer the taxes on the balance of the capital gain. In order to get the full exclusion under Section 121, it is important to use the property as a residence for two full years before converting it to investment use. Once it is converted to investment use, it should be held for at least two years (and the fair market rental and personal use tests of Rev Proc 2008-16 must be satisfied in each of the two 12-month periods thereof). Time periods **after the last personal use** are not regarded for purposes of the new Section 121 allocation rules described in Section I above (which reduce the exclusion).

On the other hand, if an Exchangor uses the property as a residence for 2 years, rents it for the next 2 years, and then moves back into it for the year before the sale, the allocation rules apply and only 3/5th of the gain is eligible for the exclusion and 2/5th is not. In addition, because the property is not held for investment purposes in each of the two 12 month periods prior to the exchange, it is not investment property under Rev Proc 2008-16 and is likely not eligible for a tax-deferred exchange upon the sale. These rules are very complicated and prior to converting your rental property you have exchanged for into a residence, it is important you consult with your tax advisor.

The Good News! The Safe Harbor requires only 14 days of rental to qualify as long as personal use is limited to 14 days!

If the math works, this Safe Harbor is a great tax-deferral planning tool to:

- A. Acquire a home for use as a primary residence after 24 months.
- B. Acquire a home for use as a second home after 24 months.
- C. Acquire a home for use as a vacation home after 24 months.
- D. Convert a personal residence to an investment property to shelter excess gain.



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WHAT TO DO AND NOT TO DO: Revenue Procedure 2008-16 and Code Section 121

GOAL #1

Exchange from Investment Property into Property Ultimately to Become Primary Home. Second Home or Vacation Property "The Really Cool Rental House"

TO DO:

For at least two years after acquisition through the exchange and for each of the two 12 month periods after the exchange:
Rent to a Third Party 14 days or more a year at Fair Market Rent (FMR) or rent to a Relative only if paying FMR and the relative is using the Property as their Primary Residence.

DO NOT:

Make personal use of the property more than 14 days a year or 10% of the time property is rented at FMR, which is greater.

Personal use, that could be disqualifying use for these purposes is use by:
the Exchangor, the Exchangor's Family members, a Co-Owner, a person with whom the Exchangor has a Time Swap arrangement or use by anyone paying less than FMR.

Fudge on Repair and Maintenance Day usage: 8 hours or 2/3rds of time the Exchangor is on the Property should be work on the property time.

GOAL #2

Covert the former Investment Property to Primary Residence, Second Home or Vacation Property

TO DO:

Meet the Test of Goal #1 above and use property more than 14 days a year or 10% of the time property is rented FMR.



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GOAL #3

Sell Primary Residence that was originally acquired by exchange (former Investment Property) and qualify for Section 121 Gain Exclusion

TO DO:

Meet all of the Tests of Rev. Procedure 2008-16. See Above but at least 2 years of Qualifying Investment Use Before Converting Property to Primary Residence.

Own the property for at least 5 years.

Occupy the property as a Primary Residence for at least 24 months out of the most recent 60 month.

Keep accurate records of all capital improvements.

Keep accurate records of depreciation taken because the amount of post 1997 depreciation will be taxed on the sale.

DO NOT:

If the Property qualifies for Section 121 Gain Exclusion as of 1/1/2009 try to avoid converting the property back to rental use. This non-qualified rental use (post 2008 rental use) will result in a pro-rata reduction in the \$250,000/\$500,000 gain exclusion. This reduction is computed on a percentage arrived at by dividing years of post 2008 rental by total years of ownership. Forget that amount of post 1997 depreciation will be taxable on the sale.

GOAL #4

Convert Primary Home into Rental for part 1031 Exchange Treatment combined with Section 121 Exclusion

TO DO:

For at least two years after converting the property to a rental and for each of the two 12 month periods after the exchange: Rent to a Third Party 14 Days or more a year at Fair Market Rent (FMR) or Rent to Relative only if paying FMR and the Relative is using the property as their Primary Residence.

Occupy the property as a Primary Residence for at least 24 months out of the most recent 60 months. Keep accurate records of all capital improvements. Keep accurate records of depreciation taken because the amount of post 1997 depreciation will be taxed on sale.

DO NOT:

Make personal use of the property more than 14 days a year or 10% of the time property is rented at FMR, whichever is greater. Personal use, which could be disqualifying use for these purposes is use by: The Exchangor, The Exchangor's Family Members, a Co-owner, a person with whom The Exchangor has a Time Swap arrangement Or use by anyone paying less than FMR.

Fudge on Repair and Maintenance Day usage: 8 hours or 2/3rds of time the Exchangor is on the Property should be work on the property time.

Move Back into the property after conversion to a rental. This personal occupancy could result in disqualifying the property for treatment as an investment property under the Fair Market Rental Rules of Rev.

Procedure 2008-16 and wipe out the 1031 exchange for part of the sales proceeds.

Forget that amount of post 1997 depreciation will be taxable on the sale.



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