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May 1, 2008

Mr. A Smith
ABC Smith Company

Dear Mr. Smith:

ATTENTION VACATION HOME OWNERS
IRS RECENTLY ISSUED FAVORABLE SAFE HARBOR RULES FOR LIKE-KIND EXCHANGE
PROPERTY HAVING LIMITED PERSONAL USE

For years, taxpayers have not had any guidance from the Internal Revenue Service (IRS) as to whether or not vacation homes qualified for the like-kind exchange treatment under Sec. 1031 of the Internal Revenue Code. This lack of guidance from the IRS often caused taxpayers to limit their exit strategies for a particular property to a more costly taxable transaction. Taxpayers need not be kept in the dark anymore!

BACKGROUND: Under Code Sec. 1031, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment. Property held for productive use in a trade or business may be swapped for property held for investment, and property held for investment may be swapped for property held for productive use in a trade or business.

Also, it has well been settled that personal residences can't be exchanged tax-free under Code Sec. 1031 because they aren't held for productive use in a trade or business or for investment.

ACKNOWLEDGEMENT: Finally, the IRS has publically stated that it recognizes that many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. "In the interest of sound tax administration," the IRS has provided taxpayers with a safe harbor under which a dwelling unit (real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities) will qualify as property held for productive use in a trade or business or for investment for Code Sec. 1031 purposes even though they occasionally use the dwelling unit for personal purposes.

The guidance, which the IRS issued on Feb. 15, 2008, by publishing Revenue Procedure 2008-16, provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment purposes for like-kind exchange treatment under Section 1031 of the Internal Revenue Code. If like-kind exchange treatment is achieved, there is no recognized gain on the exchange of properties, and the adjusted basis of the relinquished property is the substituted basis in the replacement property.

NEW SAFE HARBOR: The IRS won't challenge on personal use grounds whether a dwelling unit qualifies under Code Sec. 1031 as property held for productive use in a trade or business or for investment if:

- (a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,



- (i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
- (ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

With respect to the replacement property, a dwelling unit that a taxpayer intends to be replacement property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

- (a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and
- (b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,
 - (i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
 - (ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

EFFECTIVE DATE: Revenue Procedure 2008-16 is effective for exchanges of dwelling units occurring after Mar. 9, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units taking place before Mar. 10, 2008.

If you have any other questions on this topic, I would be happy to personally go over all of these rules with you or other tax-savings strategies that your financial situation may suggest – will work for you.

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Very truly yours,
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