

Can You Do a 1031 Exchange on a Vacation Home?

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Section 1031 of the Internal Revenue Code allows a taxpayer to defer capital gains tax by completing an exchange, often called a 1031 exchange. Section 1031 allows exchanges of business or investment property. The question that often arises is whether a vacation home or second home, with some personal use by the exchanger, can be held as an investment property allowing it qualify for an exchange. There are two major pieces of authority that provide guidance on that topic.

The first is a **Tax Court Memorandum (TCM 2007-134)**. In that case, the property was used primarily as a vacation home by the taxpayer and at no time did the taxpayer attempt to rent it. The taxpayer argued that the property was purchased with the expectation that the value of the property would increase and thus it was held as an investment. The tax court found that even though the property was held as a financial investment that does not qualify it as an investment property for the purpose of a 1031 exchange. The property was used strictly for personal use by the taxpayer as a vacation home and was never rented out. The takeaway from that ruling is that a property will not likely qualify for a 1031 exchange if it is never rented and is used strictly by the taxpayer for personal use.

That ruling prompted the IRS to issue **Revenue Procedure 2008-16** to answer the remaining question of how much rental is required in order for a property to qualify for a 1031 exchange. That Procedure covers both the relinquished property that the taxpayer is selling and the replacement property that the taxpayer acquires in the exchange. It describes the amount of rental necessary to allow the property to qualify for an exchange. Rev. Proc. 2008-16 is an IRS safe harbor meaning that the IRS has stated that they will not challenge an exchange, based on this issue, which complies with these rules. An exchange that does not comply with these safe harbor rules is possible but carries increased risk.

For the relinquished property, the follow must apply:

The property must have been owned by the taxpayer for 24 months prior to the start of the exchange and rented at a fair market rent for 14 days or more in each of the two 12 month periods in that 24 months and;

The taxpayer's personal use of the property must not exceed the greater of 14 days in each 12 month period or 10% of the number of days the property is rented in each 12 month period. For example, if a property is rented for 200 days in a 12 month period, then 10% of that rental would be 20 days. Thus, the more you rent the property the more the property can be used for personal use. However, a reasonable number of days for maintenance on the property are also allowed in addition to the personal use days! Taxpayer usage is not considered personal use if the taxpayer is engaged in repair, upkeep and

annual maintenance on a substantially full-time basis for any day. The taxpayer must be prepared to prove that the actual work was done to satisfy the IRS.

For the replacement property:

The replacement property must also be held for at least 24 months after the exchange and the personal use and rental for the two 12 month periods must meet the same 14 day/10% test that exist for the relinquished property.

Any use by a person with an ownership interest in the property or a family member will be considered personal use. A family member's use will not be considered personal use if the dwelling unit is rented at a fair market rent and the family member uses the property as their primary residence, not as a vacation home.

Also, any use where fair market rent is not paid will be considered personal use. Fair market rent is determined based on the facts and circumstances of the particular property and its location.

A Tax Court Decision in 2013 (*Adams v. Commissioner*, T.C. Memo 2013-7) sheds some light on fair market rent. The IRS challenged an exchange where a replacement property was rented to the taxpayer's son at a slightly below market rent. The court ultimately decided that since the son had been doing repairs on the property at his own cost, that made up for the below market rent and allowed the exchange to qualify. This case shows the possibility of scrutiny of fair market rent when rented by a family member.

A reading of the Revenue Procedure would conclude that there is no requirement to rent the property for more than 14 days. The property could be rented to a friend as long as there is evidence that fair market rent was paid.

Please note that the Revenue Procedure is a safe harbor. The safe harbor means that if you follow these rules your exchange will not fall under IRS scrutiny and the IRS states that they will not challenge the exchange based on this issue. If you do not meet these rules exactly, it does not preclude your exchange from qualifying, but can carry increased risk. Also, the safe harbor leaves some unanswered questions such as the validity of an exchange in a case where the taxpayer does not rent the property but also does not use it for any personal use.

Please be aware that this information is intended to provide basic information about tax deferred exchanges and is not a substitute for legal or financial advice. Gain 1031 Exchange Company strongly recommends consulting with a tax or legal advisor before considering an exchange.