

Vacation Homes

1031 EXCHANGES AND OTHER TAX ASPECTS



§1031 TAX DEFERRED EXCHANGE

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ASSET PRESERVATION, INC.

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1031 EXCHANGES AND OTHER TAX ASPECTS

Real estate in resort or vacation destinations can produce diverse and significant tax consequences. These tax consequences can be particularly critical at the time a property is sold, since many vacation destinations have appreciated significantly and property owners may be facing significant capital gain tax consequences upon disposition. The use of a tax deferred exchange under [IRC Section 1031](#) can be particularly important in disposing of such property.

This publication will first address the use of Section 1031 tax deferred exchanges in disposing of vacation properties. It will then consider a number of different scenarios, and the tax consequences of each, both while the property is owned and upon disposition of the property. Last, it concludes with a few words about converting a vacation property into an investment property eligible for Section 1031.

I. TAX TREATMENT AT DISPOSITION: QUALIFYING FOR A 1031 EXCHANGE

Internal Revenue Code Section 1031 may be available for vacation property owners seeking to defer capital gain taxes on the sale of a vacation-type property. The main issue, in most cases, is whether the properties sought to be exchanged are held “for the productive use in a trade or business or for investment,” or whether they are held exclusively for the personal use of the taxpayer. The starting point in addressing this issue is [Revenue Procedure 2008-16](#).

Rev. Proc. 2008-16 creates a “safe harbor” for exchanges of vacation property; in other words, if the specified ownership and use requirements of Rev. Proc. 2008-16 are met, the property will qualify under Section 1031. Under Rev. Proc. 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, which include a sleeping space, bathroom and cooking facilities (e.g., a residential property). The safe harbors for the relinquished property and for the replacement property are substantially the same. The IRS will not challenge whether a relinquished dwelling unit, or a replacement dwelling unit, qualifies as Section 1031 property if:

(1) the relinquished property is owned by the property owner for at least 24 months immediately prior to the exchange, or the replacement property is owned for at least 24 months immediately after the exchange (the 24-month period, whether for the relinquished property or the replacement property, is referred to as the “qualifying use period”); and

(2) within each of the two 12-month periods which make up the qualifying use period (whether for the relinquished property or the replacement property): (a) the property owner rents the property to another person or persons at a fair rental for 14 or more days; and (b) the property owner’s personal use of the dwelling unit does not exceed the greater of: 14 days, or 10% of the number of days the dwelling is rented out.

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Under Rev. Proc. 2008-16, personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes, as defined under Section 280A(d)(2) (taking into account Section 280A(d)(3) but not Section 280A(d)(4)).

Rev. Proc. 2008-16 discusses [*Barry E. Moore v. Commissioner, T.C. Memo.2007-134*](#), a 2007 Tax Court decision, which provides a good example of what will not qualify for a 1031 exchange of a vacation property. In *Moore*, the property owners exchanged a lakefront vacation property for another lakefront property. The property owners argued that both of these properties were held for investment because of the potential for long-term appreciation, and thus qualified for tax deferral under Section 1031. However, the Court concluded that neither property was held primarily for investment purposes, but were instead held for their personal use and enjoyment. In reaching this conclusion, the Court considered that: (i) the property owners never rented or attempted to rent the property to others; (ii) the property owners deducted mortgage interest as a “home mortgage interest” expense rather than investment interest expense; and (iii) the property owners did not take (and probably did not qualify for) depreciation or other tax benefits associated with an investment property including deductions for maintenance expenses.

Rev. Proc. 2008-16 provides a safe harbor for qualifying vacation homes for purposes of Section 1031, and meeting its requirements is the safest approach. But property that does not meet the requirements of Rev. Proc. 2008-16 may nevertheless qualify as relinquished or replacement property under Section 1031. There are a number of factors to consider in evaluating a possible 1031 exchange opportunity: Has the property been shown on one or more tax returns as an investment property or property used in a trade or business, including the characterization of mortgage interest as deductible investment interest expense or business expense? Are the property improvements eligible for depreciation? Is the property used substantially as a personal vacation property or second home? The characterization of residential property as held primarily for investment or for use in a trade or business is often unclear, and dependent upon the particular facts and circumstances.

II. TAX TREATMENT DURING OWNERSHIP: DIFFERENT SCENARIOS

The following sections will consider a number of different fact patterns, and the tax consequences which may arise both while a vacation-type property is owned and upon disposition of the property. These scenarios may be described as:

- A) Second home/vacation home with no rental activity;
- B) Second home/vacation home rented less than 15 days a year;
- C) Vacation home rented more than 15 days a year; or
- D) Property held primarily for investment in a vacation area.

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A) SECOND HOME/VACATION HOME WITH NO RENTAL ACTIVITY

Tax Consequences during Ownership: A second home is just that -- a second home. A second home or a vacation home held strictly for personal use with no rental activity at all is considered a second home, and does not qualify for the tax deferral benefits of a Section 1031 exchange. The mortgage interest and real estate taxes are tax deductions on Form 1040 Schedule A of the federal tax return. No other expenses, including repairs, maintenance or insurance, are deductible.

Tax Consequences at Disposition: The property owner may be able to take advantage of the exclusion from capital gain provided by [IRC Section 121](#) if they can establish this home has been their primary residence for twenty four (24) of the past sixty (60) months. Section 1031 non-recognition treatment is not available because the property has been held solely for personal use.

Keep in mind that when the property owner is splitting time between more than one residence, the IRS generally applies a couple of tests to determine which property is considered the “principal residence” for purposes of qualifying for capital gain tax exclusion under Section 121.

First, qualification as a principal residence is determined by the facts and circumstances. The property which the owner uses the majority of the time during the year will typically be considered the principal residence. However, other factors may be used in determining which property is the principal residence, as set forth in Treasury Regulation 1.121-1(b)(2). The factors include, but are not limited to:

- The time spent in a residence;
- The taxpayer's place of employment;
- The principal place of abode of the taxpayer's family members;
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- The taxpayer's mailing address for bills and correspondence;
- The location of the taxpayer's banks; and
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Second, after it has been established which property is the “principal residence,” the IRS will generally try to determine if the property owner has actually occupied the residence enough days to meet the 24 month requirement. Tax and legal advisors seeking additional guidance on these issues may also want to examine *Guinan v. United States* (2003, DC Ariz) 2003-1 USTC P 50475, 91 AFTR 2nd 2174 and *Wickersham v. Commissioner*, 2011-178.

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B) SECOND HOME/VACATION HOME RENTED LESS THAN 15 DAYS A YEAR

Tax Consequences during Ownership: If a second home/vacation home is rented less than 15 total days during the year, it is still considered a second residence. The property owner may exclude the rental income from their gross income regardless of the amount. Pursuant to IRC Section 280A, the property owner will be able to deduct the mortgage interest and property taxes but they will not be able to deduct any of the other expenses associated with renting the home, such as any necessary repairs or maintenance expenses.

Tax Consequences at Disposition: This type of usage, which is still primarily as a second residence, provides the ability to exclude capital gain taxes to the extent the property owner qualifies under Section 121. Section 1031 non-recognition treatment is not available for this type of usage as the property will be considered a primary residence.

C) VACATION HOME RENTED MORE THAN 15 DAYS A YEAR

Tax Consequences during Ownership: If a vacation home is rented more than 15 days during the year, the rental income must be included as rental income and added to gross income. The expenses associated with renting the vacation home can be deducted. The expenses associated with the vacation home must be allocated between personal and rental use and the amount of rental expenses that may be deducted will depend on the number of days the home was rented.

Tax Consequences at Disposition: This type of property may potentially qualify for a Section 1031 exchange, provided that the taxpayer and their tax advisors can establish that the 'primary purpose' of holding the property was for investment purposes. If the property owner has substantially more than two weeks of personal use per year, however, this may be difficult to establish. See discussion in Section 1, above, regarding Rev. Proc. 2008-16 and qualification under Section 1031.

D) PROPERTY HELD PRIMARILY FOR INVESTMENT IN A VACATION AREA

Tax Consequences during Ownership: If the property in a vacation area is held primarily for investment and rental purposes, then all ordinary and necessary expenses associated with the property are deductible. Ordinary and necessary expenses include, but not limited to, all of the costs incurred to repair or maintain the property, mortgage interest, insurance, real estate taxes, association or management fees, and depreciation. The rental income will be reflected on Schedule E of the property owner's federal tax return.

Tax Consequences at Disposition: This type of treatment should qualify for an exchange under Section 1031. Revenue Procedure 2008-16, as previously mentioned, provides a safe harbor for vacation property held primarily for investment that meets specific criteria.

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III. CONVERTING A VACATION HOME INTO AN INVESTMENT PROPERTY

A property owner can prepare in advance for a potential Section 1031 exchange in the future by converting a vacation home or second home into a property held for investment. There are a number of steps that can be taken to accomplish this, which may include some of the following actions:

- Keeping any personal use of the property to a minimum, under 2 weeks a year, and/or below 10% of the days the property is rented, if opting to stay within the parameters of Rev. Proc. 2008-16;
- Hiring a local property management company to make the property available for rental use;
- Listing the property for rental on popular websites such as VRBO.com, rentals.com, homeaway.com, vacationrentals.com, etc.; and
- Showing rental income on Schedule E of the property owner's tax return and other tax treatment consistent with a rental investment property.

As always, it is important to consult with your legal or tax advisor before engaging in a Section 1031 exchange. A careful review of the unique facts and circumstances of a vacation property owner's situation should be done before the decision is made to proceed with an exchange.

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A National IRC §1031 "Qualified Intermediary"

NATIONAL HEADQUARTERS
800.282.1031 | 916.791.5991

EASTERN REGIONAL OFFICE
866.394.1031 | 631.369.3617

www.apiexchange.com | info@apiexchange.com

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