



1031 Exchange Connection

By Nace Cohen, CPA
8800 Bernwood Parkway, Suite 6
Bonita Springs, FL 34135
Office: (239) 659-1031
Toll free: (888) 659-1031
Email: Nace1031@Comcast.Net
On the web: www.1031-Connection.com

1031 Exchange of Vacation Property and/or Second Homes Do Qualify

Can you 1031 exchange out of your vacation property or second home and into another "qualifying use" investment, vacation or second home on a tax-deferred basis using a 1031 exchange? There was extensive disagreement among experts as to whether or not this could be done pursuant to Section 1031.

Background of 1031 Exchanges of Vacation Homes: A History of Contradiction

Private Letter Ruling 1981-03117 was issued in 1981 by the IRS and indicated you could exchange out of vacation property and into investment property if it was held for investment as well as personal enjoyment. Our concern has always been that the PLR was old and issued a decade before the Deferred Exchange Regulations were issued.

Deferred Exchange Regulations were issued in 1991 which seemed to contradict the Private Letter Ruling by making it clear property must be held for investment or used in a business. The regulations led many 1031 experts to believe 1031 exchanges of vacation property and second homes would not qualify unless it was demonstrated the intent was to hold for investment or use in a business.

Tax Court Memorandum 2007-134 (Moore v. Commissioner) was issued May 30, 2007 and provided additional guidance. Mr. Moore's exchange did not qualify for tax-deferred exchange treatment because his intent was to hold for personal use and not investment. We now know based on this ruling that the primary intent of the taxpayer is what determines whether a property was held for personal use or for investment regardless if a secondary intent was present. It also appears your intent at the time you *sell* your property is the key issue in determining whether your intent was to hold for personal use or for investment. Your original intent at the time you acquired your property does not seem to be relevant.

The Technical Issue in Question

The primary issue that needed to be addressed and clarified by the IRS was whether a vacation property or second home that was also rented considered "qualified use property" under 1031, or if it was held for personal use and not qualify for 1031.

Treasury Inspector General Criticizes IRS

The Inspector General of the Department of the Treasury issued a report in September 2007 on 1031 exchanges entitled "**Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance**" and recommended more oversight of 1031 Exchanges by the IRS. It specifically addressed the lack of oversight and guidance regarding 1031 exchanges of vacation property and second homes.

IRS Issues Guidance on 1031 Exchanges of Vacation Properties & Second Homes

The Internal Revenue Service issued **Revenue Procedure 2008-16** in response to the Treasury Inspector General's Report. The guidance provides specific safe harbors that clarify when your vacation or second home property that was also rented is considered "qualified use property" for a 1031 exchange.

Revenue Procedure 2008-16 Provides Safe Harbors

Revenue Procedure 2008-16, effective March 10, 2008, provides a number of safe harbor guidelines that permit you to complete a 1031 of your vacation property or second home. It is important to note that Rev. Proc. 2008-16 only provides safe harbors and that a 1031 exchange of a vacation home or second home that falls outside of the safe harbor guidelines may still qualify for a 1031.

Vacation Homes or Second Homes Held as Relinquished (Sale) Properties

A vacation or second home that you are selling in a 1031 exchange will qualify for a 1031 exchange treatment if:

- It is owned by the taxpayer for at least 24 months immediately before the exchange, and
- In each of the two 12 month periods of the previous 2 years, (1) the taxpayer rents it at fair rental for 14 days or more and (2) the taxpayer's personal use does not exceed the greater of 14 days or 10 percent of the time rented during each 12 month period.

Vacation Homes or Second Homes Acquired as Like-Kind Replacement Property

A vacation home will qualify as like-kind replacement property if:

- It is owned by the taxpayer for at least 24 months immediately following the exchange, and
- In each of those two 12 month periods, (1) the taxpayer rents it to another person at fair rental for 14 days or more and (2) the taxpayer's personal use does not exceed the greater of 14 days or 10 percent of the time rented during each 12 month period.

Personal Use is Broadly Defined

Use by the taxpayer or other person having an interest in the property and any family member will be considered "personal use" by the taxpayer. Also, any arrangement where fair market rent is not paid will be considered "personal use". Use by family members will not be considered "personal use" if the property is rented at fair value. Fair rental value is based upon all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the rental agreement are taken into account.

Special Rule for Like Kind Replacement Property

If the taxpayer files a return reporting a transaction under Section 1031 based on the expectation the property would meet the qualifying use standards and subsequently determines that the property did not meet the qualifying use standards, then they may want to consider filing an amended return.

1031 Exchange May Still Be Possible if Outside the Safe Harbor Guidelines

1031 exchanges of vacation properties or second homes that do not follow the safe harbors provided within Rev. Proc. 2008-16 may still qualify for tax-deferred exchange treatment under Section 1031.

Conclusion

The issuance of Rev. Proc. 2008-16 has certainly helped clarify the issue of 1031 exchanging vacation properties and second homes, but it leaves some questions unanswered, especially if you do not fall within the safe harbor guidelines.

You must carefully analyze your transaction with your tax advisor to determine if your situation complies with Rev. Proc. 2008-16 or would support a position that your vacation home was in fact held for investment and therefore qualify for a 1031.

Certainly, the more rental, investment or business use activity the stronger your argument will be that you had intent as held for investment. The more proof you have that the property was held, treated and reported as investment property, the better your position will be for a 1031. The more personal use, the weaker your argument. Proactive planning now can help position your property for a successful 1031 exchange in the future.

Nace Cohen, CPA is an Exchange Consultant and Instructor on 1031 Exchanges based in Naples, Florida. He is the President of 1031 Exchange Connection, an independent firm of CPAs and Attorneys specializing in 1031 Exchanges and Tenant in Common Replacement Properties. All clients' funds are held in segregated accounts with Wachovia Bank. For a free consultation, call Nace (888) 659-1031, or visit www.1031-Connection.com.