



# 1031 Exchange Connection

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## IRS Issues New Ruling on Vacation Homes and 1031 Exchanges

The IRS just issued Revenue Procedure 2008-16, a new ruling that provides guidelines for taxpayers who want to do a 1031 exchange involving a vacation home. It appears the intent of the IRS was to clear up the confusion in this area; however it may just create more problems than it attempts to settle.



In a 1031 exchange, only property held for investment or used in a trade or business qualifies for tax deferral. Personal use property, such as a residence, does not qualify. The big question; **Are vacation homes investment property or personal use property?** Up until last year there was no guidance from the IRS that said vacation homes do not qualify for an exchange. That changed in a recent U.S. Tax Court decision where the taxpayer's vacation home exchange was disallowed (Moore v. Commissioner, T.C. Memo 2007-134, 5/30/07).

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One of the problems in the Moore case was the taxpayer made no attempt to argue their vacation homes were investment property; they didn't counter the IRS arguments that they were personal use homes (which in truth it sounds like they were). The court case immediately gave rise to the question of **what has to be done to qualify a vacation home for a 1031 exchange?** - This ruling is the IRS' answer to that question.

A Revenue Procedure is a "follow the instructions" ruling – it sets out what a taxpayer must do to achieve a certain result from the IRS. In this case the result is a promise from them that they will not dispute the investment nature of your vacation home. Therefore, if you follow their instructions then your property should be treated as investment property.

The ruling says in order for a vacation home to qualify, you need to hold it for a full **24 months**. This is regarding the Old Property if that is your vacation home or the New Property if you intend to buy a new vacation home, or for both if you're moving from one vacation home to another.

In addition, for each 12 month period of this holding period you must have rented the vacation home for at least 14 days at a **fair market rent**. The definition of fair market rent is determined at the time the rental is entered into. It will be interesting to find out how the IRS will monitor this since fair rent differs between properties within the same complex; it differs based on the time of year; and it differs based on who the tenants are. For example, I would rather rent my vacation home to a retired couple for less than I would rent it to a young family with kids that want to stay there during vacation.

Also during each 12 month block, the owner is only allowed to use the property for the greater of 14 days or 10% of the days rented. This means that if you rented the property for 30 days that year, you could still use it for 14 days, but if you rented it for 200 you could use it for 20. Days that relatives or friends use the unit, presumably for free, count against you unless they pay fair rent.

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Days that your partner uses the property also count against you. For example if you and John each own 50% of the property as tenants-in-common, days that John or his family use the property count against your 14 day allotment and effect your ability to do an exchange, just as your personal usage effects his. This will turn out to be a huge problem for those of you in co-ownership situations with vastly different objectives for the property.

Although not specifically discussed in the ruling, you are allowed a reasonable number of "maintenance days" to care for the unit. These days need to be reasonable - even the IRS knows that it doesn't take a week to shampoo the carpets.

This ruling is effective for sales of property taking place after March 10, 2008. This could be a problem if you are under contract to sell a vacation home that will close after that date. However, if you do not comply with the new ruling and your current contract involves a vacation home that will close after March 10, don't sweat it. Common sense dictates the IRS will get more stringent with these guidelines as time goes on and people have had a chance to comply.

So what happens if you don't meet the test? Remember: this is a safe harbor ruling – if you fail, the IRS won't automatically disallow your exchange, and they won't automatically audit you. In other words, the fact that you used the property for 15 days two years ago will not automatically fail your exchange today. At the same time, you can expect them to follow these guidelines in an audit and challenge the exchange if it fails any of the above mentioned guidelines. If you fail the guidelines and firmly believe the property is investment, then document, document, document! As the IRS can be swayed with proper substantiation since no two situations are the same.

Some of you have never rented, or tried to rent, your unit and used it two, three or four months a year the last few years; this ruling will most likely kill your exchange. Most of our clients, however, actually come very close to meeting it. My advice to all of you is to tighten up your record keeping and tax reporting of your properties. Be serious in your rental attempts; charge family members the going rental rate when they use it. Keep detailed records of the dates you use it and what you did – especially for each maintenance day. Your success at doing an exchange could very well come down to how good your records are.

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