



Trading vacation homes - by Patricia Flowers

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From Maine down the Atlantic coast, across to the lakes and ski mountains of the northeast, many people own some type of vacation or second home. Large or small, used year-round or only seasonally, it's their personal getaway. They may even consider it an investment, building upon the original structure or simply letting the value and equity grow. Unfortunately, when it comes time to sell, owners do not benefit from the same tax exclusions as that of a primary residence sale.

Many have no idea capital gains tax will apply, and possibly even the 3.8% NIIT depending on their adjusted gross income. The IRS maintains holding property solely for "personal use & enjoyment" disqualifies it from exchanging. With no proven business use (i.e. rentals), the IRS reasons that "holding this property with the hope of future gain" is simply not enough to qualify property as "held for investment" under the §1031 Tax Code.

Investors inevitably ask: "How long do I have to rent out the property? How much can I use it?" In 2008 the IRS answered: for a "dwelling unit" to qualify as property held for investment purposes and be eligible for 1031 exchange treatment, the taxpayer must have:

- 1) Owned it for 24 months immediately before the sale/exchange;
- 2) Rented it at fair market rental for 14 days or more within each of the past two 12-month periods the exchanger; and
- 3) Restricted personal use to not exceed the greater of 14 days or 10% of the total days rented within each of those 12-month periods.

Going forward, purchasing a vacation/second home as replacement property must meet the same criteria as above for the following 2 years, and the exchange itself must meet all other §1031 requirements.

Many property owners hoping to keep their investment properties “safe from damage” during those first few years will rent to those found through a rental agency, or rent to friends and acquaintances for fair market value. This will help ensure it remain in good condition for future years when the taxpayer may eventually decide to sell, or convert the investment to a personal vacation home or even their primary residence.

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