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New changes to rules on second vacation homes and 1031 exchanges: Does 2nd home qualify?

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Those who have a second-vacation home they want to sell to buy another vacation-second home elsewhere surely don't want to pay 15% capital gains and 8% state taxes. Unfortunately, second homes do not benefit from the IRS' exclusion of gain in section 121 because they don't meet the principal residence requirements. Only one option remained to defer taxes: Section 1031 tax deferred exchange. The question is whether a vacation-second home qualifies for section 1031 tax-deferral treatment.

Until recently, that question was difficult to answer. IRS rules were unclear on how to ensure that a vacation-second home qualified for tax deferral status under section 1031. In March the IRS implemented Rev. Proc. 2008-16, which set clear guidelines on how a second-vacation home can qualify as a "like kind property" under section 1031. These guidelines ensure the IRS will not challenge if a vacation-second home qualifies as property held for productive use in a trade or business or for investment in order to be eligible for safe harbor protection under section 1031.

Under IRS section 1031, no gain or loss is recognized on the sale of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of "like kind" that is to be held either for productive use in a trade or business or for investment (replacement property). As far back as 1959, the IRS concluded that gain or loss from an exchange of personal residences may not be deferred under Section 1031 because they are not held for productive use in a trade or business or for investment. (See *Moore v. Commissioner*)

The next consideration was whether vacation-second homes minimally used by taxpayers could qualify under section 1031 for tax deferral treatment. Could the property meet the criteria of an investment and thereby qualify for Section 1031 tax deferral treatment if the vacation-second home was only rented for a short period of time each year?

Section 280A covered the issue of allowing deductions on any property that taxpayers used as residences including vacation and second homes. This section stated that a taxpayer who personally uses the dwelling unit the greater of 14 days a year or 10% of the number of days during the year for which the property is rented at fair market value, is using the property as a "residence" and not as an "investment." "Personal use" under this section not only included use by the taxpayer but also use by any member of the taxpayer's family, or anyone who was a co-owner; or use by any person utilizing the property under an agreement which enabled the taxpayer to use some other property, whether or not a rental was charged for the use of the other property, or if in fact the individual rented the unit for less than fair market value.

Knowing that many taxpayers hold second-vacation homes primarily for production of rental income, but at the same time occasionally use the property for their own personal use, the IRS recently

produced Rev. Proc. 2008-16 to clarify some of these issues.

Under Rev. Proc. 2008-16, the IRS will not challenge whether a vacation-second home (house, apartment, condominium, etc.) qualifies under section 1031 as property held for investment or held for productive use in a trade or business if:

1. For the relinquished property:

- (a) the second-vacation home is owned by the taxpayer for at least 24 months immediately before the exchange and,
- (b) Within the qualifying use period, in each of the two 12 month periods immediately preceding the Exchange:
- (c) The taxpayer rents the vacation-second home, at fair rent, for at least 14 days or more to another person/persons, and
- (d) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.

Similar rules apply to the replacement property.

2. For the replacement property:

- (a) The second-vacation home must be owned by the taxpayer for 24 months or more immediately after the exchange; and
- (b) Within each of the two 12-month periods immediately after the exchange:
- (c) The taxpayer must rent, at fair rent, to another person/ persons for at least 14 days or more, and
- (d) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented to another at a fair rental rate.

This article is to be continued in the April 4th edition of the New England Real Estate Journal.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540