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Vacation homes and 1031 Exchange: What are the tax implication when selling a vacation home? - by John Starling

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The IRS provides tax benefits for the sale of real estate classified as either your primary residence (IRC 121) or investment property (IRC 1031). But what about vacation homes? What are the tax implication when selling a vacation home? Let's discuss the safe harbor revenue procedure that help clarify this gray area. If the vacation home is used exclusively by the owner for more than 14 days per tax year and never rented out, the guidelines are clear. This sale will not qualify for a 1031 tax deferred exchange and the sale will be subject to federal capital gains tax and state tax and probably the federal "net investment income tax."

When the property is exclusively rented to others at a fair market rate with no personal use time and all operating income, expenses and depreciation are reported on Schedule E of the exchangers tax return, the property will qualify for a code 1031 tax deferred exchange.

Now, on to the gray area. What if an owner uses the property for vacation and rents it out? Revenue Procedure 2008-16 creates a safe harbor for vacation home exchanges. IRS will consider a dwelling unit held for investment if certain criteria are met.

- The relinquished and replacement properties are owned by the taxpayer for at least 24 months (the qualifying use period)
- Within each of these two 12 month periods constituting the qualifying use period, the tax payer must 1.) Rent the property to another person at fair market rent for 14 or more days (family members qualify if they use the property as primary residence) and 2.) The taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the time it is rented.

So you can see how a vacation home can be considered investment property that qualifies for a 1031 tax deferred exchange. This is a very important issue since sales reports indicate that 25% to 35% of current real estate transactions involve a second home, and the appreciation on second homes has been sky rocketing.

If your property doesn't meet the above safe harbor guidelines, does that mean you can't do an exchange? It does not, you may very well be able to exchange because the procedure clearly says that if you meet the stated criterion your exchange will not be challenged by the IRS as a "safe harbor" exchange. It was never intended to state when a 1031 exchange can otherwise be accomplished. Let's look at some situations that don't meet the "safe harbor" guidelines established in the 2008-16 revenue procedure but should however qualify. Say for instance, your second home is held vacant with no personal use and never rented in anticipation of an increase in value, the property would be considered held for investment and should qualify for a like-kind exchange. Another situation could be that you clearly used the property more than 14 days during each of the two 12 month periods immediately prior to its sale. Let's examine "personal use" time and its definition published in IRS Tax Topic 415 and §280A-(c)(1) which describes a day of personal use of a dwelling unit as any day that it is used by: 1.) The taxpayer or any other person who has an interest in it (co-owner), unless the interest is rented to another owner as his or her main home under a shared equity financing agreement; 2.) A member of the taxpayer's family or a family member of any other person who has an interest in it, unless the family member uses it as his or her main home and pays a fair rental price; 3.) Anyone under an agreement that lets the taxpayer use some other dwelling unit; or 4.) Anyone at less than fair market rental price. Any day in which the taxpayer does substantially full-time repairs or maintenance, even while others there enjoy themselves, will not be counted as a personal use day. So if you are there fixing it up or performing maintenance work and the family comes with you, those days do not count as part of your 14 day personal use period. If you're like me the kids and spouse are on the beach or the waterway and I'm painting or performing small maintenance jobs for the whole week. I do this once a quarter opening it up for the season in the spring, performing mid-season deep cleaning and repair work or overseeing these activities and winterizing it at the end of the season. I visit the property occasionally to check on the rental management company and meet with them to oversee their marketing and showing activities. Finally I take a real vacation at the property for a week in the summer and a week in the fall and do nothing except enjoy my family time and I count those days as my "personal use" days.

It may be noteworthy to mention that if you have rental income, then you report it to the IRS on Form 1040, Schedule E. This form reports for each rental real estate property the income, allowable expenses and depreciation taken. Also of importance, on line 2 of Schedule E, for each rental property listed, you must answer yes or no to "did you or your family use it for personal purposes for more than the greater of 14 days or 10% of the actual days rented at fair rental value during the tax year?" To qualify for a 1031 exchange, the Schedule E should reflect that personal use of the property was limited. If your property has been held for personal use and you now wish to convert it to business use so that you may complete a 1031 exchange, it is important that you discuss the details with your CPA or tax adviser.

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