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Qualifying vacation property as investment - by Lynne Bagby

May 31, 2019 - Spotlights

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Finally, the weather is beginning to break here in New England! Everyone appears to be thinking about their summer plans and spending time at a beach on Cape Cod, Newport, Old Orchard or on Lake Winnepesaukee. Investors should read this article to ensure that if they ever want to sell their vacation home, they have the option of receiving favorable tax treatment. The tax consequences can be particularly critical at the time a property is sold, since many vacation destinations have appreciated and property owners may be facing significant capital gain tax consequences upon disposition. The use of a tax deferred exchange under IRC Section 1031 can be particularly important in disposing of such property—if such property can qualify as “held for investment”.

Tax Treatment at Disposition: Qualifying for a 1031 Exchange

Internal Revenue Code Section 1031 may be available for vacation property owners seeking to defer capital gain taxes on the sale of a vacation-type property. The main issue, in most cases, is whether the property to be exchanged is held “for the productive use in a trade or business or for investment,” or whether held exclusively for the personal use of the taxpayer. The starting point in addressing this issue is Revenue Procedure 2008-16.

Rev. Proc. 2008-16 creates a “safe harbor” for exchanges of vacation property; in other words, if the specified ownership and use requirements of Rev. Proc. 2008-16 are met, the property will qualify for tax deferral under Section 1031. Under Rev. Proc. 2008-16, a “dwelling unit” is defined as any real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations, which include a sleeping space, bathroom and cooking facilities (e.g., a residential property). The safe harbors for the relinquished property and for the replacement property are substantially the same. The IRS will not challenge whether a relinquished dwelling unit, or a replacement dwelling unit, qualifies as Section 1031 property if:

1. The relinquished property is owned by the property owner for at least 24 months immediately prior to the exchange, or the replacement property is owned for at least 24 months immediately after the exchange (the 24-month period, whether for the relinquished property or the replacement property,

is referred to as the “qualifying use period”); and

2. Within each of the two 12-month periods which make up the qualifying use period (whether for the relinquished property or the replacement property):

- The property owner rents the property to another person or persons at a fair rental for 14 or more days; and
- The property owner’s personal use of the dwelling unit does not exceed the greater of: 14 days, or 10% of the number of days the dwelling is rented out.

Under Rev. Proc. 2008-16, personal use of a dwelling unit occurs on any day in which the taxpayer is deemed to use the property for personal purposes.

Rev. Proc. 2008-16 discusses *Barry Moore v. Commissioner*, T.C. Memo. 2007-134, a 2007 Tax Court decision, which provides a good example of what will not qualify for a 1031 exchange of a vacation property. In *Moore*, the property owners exchanged a lakefront vacation property for another lakefront property. The property owners argued that both of these properties were held for investment, because of the potential for long-term appreciation, and thus qualified for tax deferral under Section 1031. However, the tax court concluded that neither property was held primarily for investment purposes, but were instead held for their personal use and enjoyment. In reaching this conclusion, the court considered that:

- The property owners never rented or attempted to rent the property to others;
- The property owners deducted mortgage interest as a “home mortgage interest” expense, rather than investment interest expense; and
- The property owners did not take (and probably did not qualify for) depreciation or other tax benefits associated with an investment property including deductions for maintenance expenses.

Rev. Proc. 2008-16 provides a safe harbor for qualifying vacation homes for purposes of Section 1031, and meeting its requirements is likely critical to qualifying a vacation home under Section 1031. A vacation property that does not meet the requirements of Rev. Proc. 2008-16 will likely not qualify for Section 1031 exchange tax deferral.

Converting a Vacation or 2nd Home into an Investment Property

A property owner can prepare in advance for a potential Section 1031 exchange in the future by converting their vacation home or second home into a property held for investment. There are a number of steps that can be taken to accomplish this, which may include some of the following actions:

- Keeping any personal use of the property to a minimum, under two weeks a year, and/or below 10% of the days the property is rented.

- Leasing the property as much as feasible, given its location;
- Retaining written records of all leases, leasing activities and listings for lease;
- Hiring a local property management company to make the property available for rental use;
- Listing the property for rental on popular websites such as VRBO.com, rentals.com, homeaway.com, vacationrentals.com, etc.; and
- Showing rental income and expenses on Schedule E of the property owner's tax return and other tax treatment consistent with a rental investment property.

As always, it is important for taxpayers to consult with their tax and legal advisors before engaging in a Section 1031 exchange. A careful review of the unique facts and circumstances of a vacation property owner's situation should be done before the decision is made to proceed with a 1031 exchange.

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