

1031 Exchanges & Vacation Homes

Exchanging Out of / Into a Vacation Home or Short-Term rental with Personal Use



CAN I PERFORM A 1031 EXCHANGE ON MY FAMILY VACATION HOME?

While you cannot make a Section 1031 exchange out of a vacation home that you have used strictly for personal purposes, all is not lost. You can still set yourself up for a future Section 1031 exchange by renting the property out for enough days over the next 24 months to meet the Relinquished Property safe harbor guidelines. Then you can find a suitable Replacement Property and do a Section 1031 exchange.

For investors hoping to mitigate capital gains taxes while having some personal use on a property involved in a Section 1031 Exchange, **Revenue Procedure 2008-16** checks all the right boxes. Rev. Proc. 2008-16 provides a safe harbor for certain transactions that involve property used for personal use. In summary, the IRS has approved investors to classify property as real estate held as a vacation home so long as the property is held for productive use in a business or for investment. Owners must abide by the strict rules as outlined below.

To tee up a family vacation home for an eventual 1031 exchange:

The Relinquished dwelling is owned by the taxpayer for at least 24 months prior to the exchange.

In each of the two 12-month periods constituting the qualifying use period:

1. Taxpayer rents the property at Fair Market Value for a minimum of 14 days.
2. The taxpayer's personal use does not exceed the greater of 14 days or 10 percent of the time is rented. E.g., Rent 200 days in a given 12 months, taxpayer may use for 20 days.

We call these the 3 Rules of 2s: two years, two weeks rent per 12-month period and 2 weeks personal use per year. Now the former family vacation home qualifies for a Section 1031 tax-deferred Exchange.

CAN I EXCHANGE INTO A VACATION PROPERTY OR A SHORT-TERM RENTAL (STR) WITH SOME PERSONAL USE IN MY 1031 EXCHANGE?

The short answer is, yes. However, there are rules that the exchanger needs to abide by for the first two years. After purchasing a vacation home or a STR, the exchanger should follow Revenue Procedure 2008-16 post-exchange. Revenue procedures give guidelines to the Treasury Regulations.

"3 RULES OF 2S"

1. Taxpayer seasons their intent to hold the property as an investment for a minimum of **2 years** post-exchange. Declaring rental income, depreciation and other expenses associated with owning an investment property.
2. Taxpayer must rent for a minimum of **2 weeks** (14 nights) within each 12-month period for the first **2 years**.
3. **Personal use** is limited to **2 weeks** within each 12-month period in the first **2 years**. Or 10% of the time it is rented, whichever is greater (rent for 200 days one year, you may use for 20 days).

After seasoning your intent to hold for investment 2 years post-exchange, declared on a minimum of two tax filings, your intent changes (no form to fill out).

You may then opt to keep the property as a short-term rental with more personal use, or have as a second home, or maybe you move into it as your primary residence.

This is a popular tax strategy for a second or primary home.