



A Publication of Starker Services, Inc.

The Second Home / Vacation Home Exchange

INTRODUCTION

Many U.S. residents have the good fortune to own a second home or vacation home. With ownership of such a luxury item can come unexpected costs in the form of capital gains tax upon a sale. Property owners selling a second home/vacation home, held mainly for personal use, are not provided a means of deferring or excluding capital gain realized due to an increase in the property's value. Unlike business property (such as a rental home or commercial property), and investment property (such as bare land), personal use property does not fall within the scope of Internal Revenue Code Section 1031 ("IRC §1031"). IRC §1031 allows the exchange of appreciated property and deferment of realized capital gain to a replacement property if the replacement is acquired within 180 days from the date of sale and a qualified intermediary is employed to produce the documentation required by the IRS. Certain property by its nature does not qualify for tax deferral.

SAFE HARBOR FOR VACATION HOME EXCHANGES

Revenue Procedure 2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section §1031.¹ The safe harbor is effective for exchanges occurring on or after March 10, 2008. A dwelling unit that a taxpayer intends to be used as a Relinquished or Replacement property in a §1031 exchange qualifies if:

Relinquished Property: Must be owned by the taxpayer for at least 24 months immediately prior to the exchange. In each of the two 12-month periods immediately preceding the start of the exchange:

- (i) The taxpayer must rent the relinquished property to another person at a fair market rent for 14 days or more (cannot include renting to a related party), and
- (ii) The taxpayer's personal use of the relinquished property cannot exceed the greater of 14 days or 10% of the days during the 12-month period the relinquished property is rented at a fair market rent.

Replacement Property: Must be owned by the taxpayer for at least 24 months immediately after the exchange. In each of the two 12-month periods immediately after the exchange, the taxpayer must follow the same rules as listed above for the Relinquished Property.

MINIMAL PERSONAL USE

A taxpayer is deemed to have used a dwelling unit for personal purposes if used by (A) the taxpayer or any other person who has an interest in such unit (including a tenant in common), or by any member of the family of the taxpayer or such other person (related parties under section 267); (B) any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or (C) any individual if rented for less than fair market value.

Family Members: A taxpayer may rent the dwelling unit to a family member if the family member uses it as a principle residence (and not a vacation home) and the family member pays fair market rent.

Maintenance & Use: The taxpayer may use the dwelling some additional days for repairs and annual maintenance however be prepared to prove actual work done. (See Section 280A(d)(2) and (3)).

Internal Revenue Code Section 280A contains rules which may serve as guidelines on personal use limits and deduction of losses in determining whether a property qualifies as a business property. The presumption is a property owner can occupy their unit for a minimum of 14 days² a year without altering its character to personal use property. The maximum personal usage will depend on the number of days the property is rented.³ For example, if a property was rented for 250 days during a year, then it can be used up to 25 days for personal use.

Section 280A states, in part, that [n]o deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.⁴ In other words, this code section prevents taxpayers from taking otherwise allowable deductions on a property that is not used for a business purpose. Second homes are typically properties that would not qualify for business deductions since they are being held for personal enjoyment. The traditional rule is personal living expenses are not deductible, except to the extent of non-business deductions, such as interest and taxes.⁵ The inability to take business deductions would make it difficult to color a property as like kind property eligible for exchange.

CONVERSION TO PERSONAL RESIDENCE

While specifically addressing the vacation home issue, this Revenue Procedure indirectly addresses the issue of converting a principal residence into qualifying relinquished property prior to an exchange, or converting replacement property into a personal residence after an exchange. The two-year holding period should meet the safe harbor standards. A second home or vacation home converted to a principal residence instead of rental property can give taxpayers another potential method of nonrecognition of capital gains. This can be accomplished by moving into the property and occupying it for a minimum of two years as a principal residence. There is no taxable event when converting property from one use to another. Upon its sale, an exclusion of up to \$250,000.00 in capital gains if single, and \$500,000.00 if married filing jointly, from the sale of a principal residence is available.⁶ Provided this exclusion allowance had not been used by the taxpayer within the previous 24 months, any gain realized upon the sale, up to the maximum limits, would be excluded from income.

The ability of the taxpayer to alternate between two properties during a year and exclude the gain on either property when sold would be limited. The Service has proposed regulations that allow exclusion of gain only upon the sale of the residence used the majority of time during the tax year. Taxpayers should be careful when converting rental property received in an exchange to personal use property. They should predominantly occupy that property and not their previous residence if they intend for a principal residence sale of this property at some future date. If originally received in an exchange, the IRS also requires the taxpayer to own the property for a total of 5 years before qualifying for the exclusion of gain (\$250K or \$500K).

EXAMPLE

A married couple has owned their second home on the lake for ten years. Every year, they spend several weekends in the spring and the entire summer enjoying their lake home with family and friends. The home has appreciated considerably and they have never rented it. The couple wants to sell the lake home and invest in an apartment building that will generate income. They spend the next two years renting the lake home to friends for at least 14 days each year.⁷ They cut back their personal use to two weeks during the summer. After the two years pass, they can defer their capital gain taxes through a 1031 exchange into the apartment building.

CONCLUSION

Whenever employing any of the above techniques, it is always advisable to check with your tax advisor before proceeding. While these guidelines provide a taxpayer a safe harbor, an exchange may fall outside these parameters and still meet the statutory requirements. You should however expect heightened scrutiny in such a case. With advice from tax counsel and proper planning, a second home or vacation home can still be sold pursuant to an exchange transaction without costing its owner a fortune in taxes.

¹ Internal Revenue Code §1031, Revenue Procedure 2008-16

² Internal Revenue Code §280A(d)(1)(A)

³ Internal Revenue Code §280A(d)(1)(B)

⁴ Internal Revenue Code §280A(a)

⁵ Internal Revenue Code §280A(b)

⁶ Internal Revenue Code §121(b)

⁷ Internal Revenue Code §121(d), as amended by Section 840, American Jobs Creation Act of 2004

This material is provided for informational purposes only and is not to be construed as tax advice. The reader is strongly advised to speak with a tax consultant before attempting to employ any of the concepts stated herein.

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