

Real Estate Journal

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Vacation homes - Do they qualify for provisions of Internal Revenue Code § 1031

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Whether it's a condo in Florida or a cottage on Cape Cod, many taxpayers own second homes. The question that inevitably arises is whether the "vacation home" satisfies the qualified use provisions of IRC §1031. The answer depends on the owner's use of the property.

Use of Vacation Home

Property will not be eligible for a 1031 exchange unless it is held by the taxpayer for either productive use as in a trade or business or for investment. A trade or business includes rental property. A vacation home, however, may be held solely (or primarily) for personal use by the taxpayer. If held for personal use, can it also be "held for investment" for 1031 purposes?

Neither IRC § 1031 nor the Regulations define "held for investment", but the 1031 Regulations do provide that "unproductive real estate held by a non-dealer for future use or future appreciation is held for investment." In a

private letter ruling, the IRS ruled that a taxpayer held property for investment where he occupied the same for ten days each year for the sole purpose of maintenance (i.e. the use was not for personal enjoyment).

Service's Position

The IRS maintains that a vacation home can only be considered investment property if losses from the sale or exchange of such property would be deductible. IRC §280A(d), which governs the allowance of deductions (and presumably the deductibility of losses) from a "dwelling unit" that a taxpayer uses as a residence, including a second or vacation home, must be examined to determine whether a vacation home qualifies as investment property.

§280A disallows losses with respect to a dwelling unit used as a residence by the taxpayer during the taxable year. The unit is considered to be a residence if used by the taxpayer for personal use for more than 14 days, or 10% of the number of days during the year for which such unit is rented for fair market value. Personal use includes use by those related to the taxpayer, unless the relatives are using the same as a principal residence and paying fair market rent, and use by renters paying less than fair rental.

If a dwelling unit is a personal

unit that is rented for more than 14 days out of the year, a limited amount of any losses may be deducted on a prorated basis. Based on the foregoing, it seems that a taxpayer could defer a prorated portion of any gain through a like kind exchange.

Although IRC §280A seems to control in determining whether a vacation home qualifies as investment property, losses on the sale of investment property can also be deducted under IRC §165, which allows that losses may be deducted if the transaction was entered into for a profit. A profitable sale must be the primary motive, not a secondary one. Accordingly, to deduct a loss under IRC §165 (and the exchange under §1031) the vacation home must have been purchased with turning a profit as the primary motive.

Planning Tips

A taxpayer who uses a vacation home for personal use more than incidentally will be hard pressed to qualify the same as investment property eligible for like kind exchange treatment. With proper planning, however, the taxpayer should be able to qualify their use of the property as follows:

A. The taxpayer should not exceed the personal use limitations of §280A(d) during the year of the sale;

B. The property should be rented at fair market rent during the year of the sale (or at least listed for rental). There is no bright line test for the length of time the residence must be rented out—often one year is recommended but there is no direct authority for this;

C. If the personal use is significant, consider converting the vacation home to the taxpayer's principal residence in order to qualify the residence for the gain exclusion under IRC § 121. If the taxpayer acquired the vacation home in a like-kind exchange, however, the \$250,000/\$500,000 exclusion that applies to gain realized on the sale or exchange of a principal residence under IRC § 121(a) does not apply to the sale or exchange of the vacation home if the sale or exchange occurs during the five-year period beginning with the date of the acquisition of the vacation home.

Due to the uncertainty in the law and the complexities involved, any taxpayer considering the sale of a vacation home should contact a tax professional experienced in analyzing the issues involved.

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