

# New Changes to Rules on Vacation-Second Homes

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Individuals who have a vacation-second home they want to sell to buy another vacation-second home elsewhere do not want to pay 15 percent capital gains and 8 percent state taxes. Unfortunately, second homes do not benefit from the IRS' exclusion of gain in Section 121 because they do not meet the principal residence requirements. Only one option remains to defer taxes: Section 1031 Tax Deferred Exchange. Does a vacation-second home qualify for Section 1031 tax deferral treatment?

Until recently, that question was difficult to answer. IRS rules were unclear on how to ensure that a vacation-second home qualified for tax deferral status under Section 1031. In March the IRS implemented Rev. Proc. 2008-16, which set clear guidelines on how a vacation-second home can qualify as a "like-kind property" under Section 1031. These guidelines ensure the IRS will not challenge if a vacation-second home qualifies as property held for productive use in a trade or business or for investment in order to be eligible for safe harbor protection under Section 1031.

## Background

Under IRS Section 1031, no gain or loss is recognized on the sale of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of "like-kind" that is to be held either for productive use in a trade or business or for investment (replacement property). As far back as 1959, the IRS concluded that gain or loss from an Exchange of personal residences may not be deferred under Section 1031, because they are not held for productive use in a trade or business or for investment. (See *Moore v. Commissioner*)

The next consideration was whether vacation-second homes minimally used by taxpayers could qualify under Section

1031 for tax deferral treatment.

Section 280A covered the issue of allowing deductions on any property that taxpayers used as residences including vacation and second homes. This section stated that a taxpayer who personally uses the dwelling unit the greater of 14 days a year or 10 percent of the number of days during the year for which the property is rented at fair market value, is using the property as a "residence."

"Personal use" under this section not only includes use by the taxpayer, but also use by any member of the taxpayer's family, or anyone who is a co-owner; or use by any person utilizing the property under an agreement which enabled the taxpayer to use the property, whether or not a rental was charged for use, or if in fact the individual rented the unit for less than fair market value.

## Clearer Rules

Knowing that many taxpayers hold vacation-second homes primarily for production of rental income, but at the same time occasionally use the property for their own personal use, the IRS recently produced Rev. Proc. 2008-16 to clarify some of these issues.

Under Rev. Proc. 2008-16, the IRS will not challenge whether a vacation-second home (house, apartment, condominium, etc.) qualifies under Section 1031 as property held for investment or held for productive use in a trade or business if:

- (1) For the Relinquished Property:
  - (a) the vacation-second home is owned by the taxpayer for at least 24 months immediately before the Exchange and,
  - (b) Within the qualifying use period, in each of the two 12 month periods immediately preceding the Exchange:
    - (i) The taxpayer rents the vacation-second home, at fair rent, for at least 14 days or more to another person/persons, and
    - (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10 percent of the number of days during the 12 month period that the dwelling unit was rented to another at a fair rental rate.
- (2) For the Replacement Property:
  - (c) The vacation-second home must be owned by the taxpayer for 24 months or more immediately after the Exchange; and
  - (d) Within each of the two 12 month periods immediately after the Exchange:

- (i) The taxpayer must rent, at fair rent, to another person/ persons for at least 14 days or more, and
- (ii) The taxpayer may not personally use the dwelling unit the greater of 14 days or 10 percent of the number of days during the 12 month period that the dwelling unit was rented to another at a fair rental rate.

Fair rental includes all of the "facts and circumstances" that existed when the rental agreement was entered into between the parties and all of the rights and obligations of the parties to the rental agreement.

If the taxpayer files his/her federal income tax return and reports the transaction as a Section 1031 Exchange, believing that the vacation-second home used as a replacement property will meet the appropriate qualifying standards, and then it is determined that the replacement property does not meet the necessary qualifying standards, the IRS will suggest that the taxpayer file an amended return and not report the transaction as an Exchange under Section 1031.

Rev. Proc. 2008-16 is limited in that it only determines whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031. It does not give safe harbor protection for all of the other requirements for a "like-kind" Exchange under Section 1031 or under the Section 1031 Regulations.

What happens if the vacation-second home does not qualify under Rev. Proc. 2008-16 for safe harbor protection? The taxpayer may still try to qualify for Section 1031 treatment but will have to overcome the requirements set forth in Rev. Proc. 2008-16, which went into effect on March 10, 2008.

Rev. Proc. 2008-16 does clear the air on many issues surrounding 1031 Exchanges for vacation and second homes. Taxpayers will still have to satisfy any and all of the other requirements for a like-kind Exchange in order to qualify for tax deferred treatment.

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