Vacation homes and second homes (hereinafter collectively referred to as “vacation homes”) do not qualify for personal purposes do not qualify for tax deferral under Section 1031. In May 2007 the U.S. Tax Court in Moore v. Commissioner, T.C. Memo 2007-134, held that the mere hope or expectation that a vacation home would appreciate in value did not establish investment intent to qualify the property for a 1031 Exchange.

The following year, the IRS issued guidance in Revenue Procedure 2008-16 relating to how long a vacation home must be rented and how much it can be used for personal purposes to become eligible for a 1031 Exchange. In addition, the Revenue Procedure provides if a taxpayer complies with the requirements set forth in it, the IRS will not challenge the validity of the 1031 Exchange. A dwelling unit is defined as “real property improved with a house, apartment, condominium or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.”

To comply with Revenue Procedure 2008-16, the vacation home (being converted to Relinquished Property):

1. Must have been owned by the taxpayer for at least two years prior to the 1031 Exchange;
2. Must have been rented for at least 14 days (at fair market value) in each of the two 12 month periods immediately prior to the Exchange; and
3. Was not used for personal purposes for more than 14 days or 10 percent of the actual rental period (whichever is greater) during each of the two 12 month periods prior to the 1031 Exchange.

The language referencing, the greater, of 14 days or 10% of the rental period may sound confusing but is not as limiting as it appears. For example, if the vacation home is actually rented for 500 days per year, the personal use could be up to 30 days. However, if it is rented for the minimum specified by the Revenue Procedure (14 days), the personal use must be limited to 14 days per year. Personal use includes use by Exchanger’s friends and family members that do not pay fair market rent but would not include use as related party’s primary residence if the related party pays rent at a fair market rate. Adams v. C.I.R., T.C.M. 2013-7.

The paragraph above describes how the Revenue Procedure applies to a vacation home being sold (the Relinquished Property). However, the Revenue Procedure also applies to Replacement Property; the requirements are just reversed. As a result, Revenue Procedure 2008-16 provides a way to buy a future primary residence, second home or vacation property (“personal use property”) as an exit strategy from investment real estate.

The following is an illustration of how that might be achieved. First, sell investment property and acquire a future personal use property as the Replacement Property in the 1031 Exchange. Second, rent the property for at least 14 days during each of the first two 12 month periods after the exchange. As stated above, it can be rented to a family member as long as it is their primary residence and they pay fair market rent. Third, make sure the personal use is no more than 14 days (or 10 percent of the actual rental period) in each of the two 12 month periods after the exchange. Finally, move into the property or otherwise use it for personal use!

In summary, a taxpayer can take a vacation home or a personal use property, rent it for fair market rent for at least 14 days per year for two years before the 1031 Exchange and then exchange out of it without having the IRS question whether it qualified for tax deferral under Section 1031. Likewise, the taxpayer can do the same thing on the Replacement Property for two years after the exchange and thereby convert the rental into a personal use property with the certainty of the “safe harbor” provided by the Revenue Procedure. Although this Revenue Procedure is strict with regard to the personal use allowed it is still “taxpayer friendly”.