

How to Buy Your “Dream Home” with a 1031 Exchange

In 2008, the IRS issued Revenue Procedure 2008-16. It provides a “blueprint” to make a vacation/ second home (hereinafter referred to as vacation home) eligible for a 1031 Exchange. In the Revenue Procedure, the Internal Revenue Service stated that if a taxpayer complies with the requirements of Revenue Procedure 2008-16, it will not challenge the validity of the 1031 Exchange.

To comply with Revenue Procedure 2008-16 the vacation home:

- 1) Must have been owned by the taxpayer for at least two years prior to the 1031 Exchange;
- 2) Was rented for at least 14 days (at fair market value) in each of the two years immediately prior to the exchange; and
- 3) Was not used for personal purposes more than 14 days or 10 percent of the rental period (whichever is greater) during each of those two years. To simplify the confusing language of the third requirement; if you rent a vacation home for 300 days, your personal use could be up to 30 days.

The paragraph above describes how the Revenue Procedure applies to a vacation home being sold (the relinquished property). While this may be helpful for taxpayers who plan, many taxpayers are frustrated by the third requirement limiting their personal use. However, the Revenue Procedure also applies to property being purchased in an exchange, in reverse. That is where the true gift from the IRS exists; they gave us a way to buy our dream house as an exit strategy from investment property.

Here is how it works. Sell your investment property and do a 1031 Exchange acquiring your future “dream house” as the replacement property. Rent the property to friends for at least 14 days during the first two years after the exchange. Make sure your personal use is no more than 14 days in each year. Then move into it for the rest of your life!

Why rent to friends? The Revenue Procedure will not recognize renting to relatives (even at fair market value) and most people do not want to put their “dream house” in a rental pool for fear that tenants might “trash it”. Accordingly, renting to friends gives a way of complying with the rental requirements of the Revenue Procedure without risking damage to the property.

Taxpayers and their advisors sought guidance from the IRS concerning how much personal use was permissible with regard to a vacation property which was owned for investment. After years of silence, the IRS has spoken and given us a huge gift which we can use to gain personal benefit from our investment properties.

Who said the kinder, gentler IRS disappeared?

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