

Revenue Procedure 2008-16

Vacation homes and second homes (hereinafter collectively referred to as “vacation homes”) used primarily for **personal purposes** do not qualify for tax deferral under Section 1031. In May 2007 the U.S. Tax Court in *Moore v. Commissioner*, held that the mere expectation that a vacation home would appreciate in value did not create an “investment property” to permit it to be part of 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.

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 years 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 years 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 300 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.

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 property being purchased in an exchange; 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 years after the exchange. 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 years 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” since it provides an approved way to convert properties and because the IRS does not require the taxpayer to pay any taxes on the gain attributable to the personal use.