



1031 Qualification for Vacation Homes Remains a Contentious Issue

By Ed Horan, *Certified Exchange Specialist*[®]

Less than a year ago I wrote in this column that there was a great deal of disagreement over the qualification of vacation and second homes for an IRC 1031 like-kind exchange. Obviously, readers of this paper have a special interest in the outcome of this issue.

Instead of the IRS addressing the issue and providing definitive guidance, the debate has become more contentious. Taxpayers who own vacation homes are receiving conflicting advice from fully qualified real estate professionals, CPAs and tax attorneys.

To qualify for a like-kind exchange, IRC Section 1031 requires that both the relinquished property and the replacement property be “held for productive use in a trade or business or for investment.” It is clear a property will fully qualify when it is being held for use in a trade or business. Thus, the basic and most often asked question becomes – When is a vacation home being held for investment?

In our previous article, in order to better understand the issue, we categorized how second homes are used. These categories are repeated below.

1. **RENTAL ONLY:** It is clear that a property that is exclusively rented at a fair market value qualifies for a like-kind exchange. All operating income, expenses and depreciation are reported on Schedule E of the taxpayer’s IRS Form 1040.
2. **RENTAL WITH RESTRICTED PERSONAL USE:** Personal use is within the time restrictions as set forth in IRC Section 280A. Restricted personal use is considered as no more than 14 days or 10% of the days actually rented at a fair market rental price, whichever is greater. Such a rental would be considered as being held for business purposes under Section 1031. Thus, it is accepted within the exchange industry that a rental with restricted personal use should qualify for a like-kind exchange.
3. **PART PERSONAL USE AND PART RENTAL USE:** The controversial part of this issue occurs when the personal use exceeds the limitations of IRC Section 280A, but the property is rented for part of the year. If the personal use limitations are exceeded, then the property is not considered as being held for business but could qualify as an investment property. Most practitioners maintain that Section 280A does not determine if the property can qualify for a like-kind exchange. What Section 280A does is establish specific rules on what tax deductions can be taken if personal use exceeds the established limits. Basically rental expense deductions cannot exceed gross rental income. If the taxpayer has used a second home in excess of the 14 day or 10% of days actually rented (Section 280A criteria), they need to recognize that the IRS may review the facts to determine if the taxpayer had a primary profit and investment motive.
4. **PERSONAL USE – RENTAL NOT IN EXCESS OF 14 DAYS:** IRC Section 280 permits both a principal residence and a second home to be rented out for no greater than 14 days without claiming either income or expenses. There should be no question that the primary use of the property is personal use and thus it would not qualify for a like-kind exchange.

5. **PERSONAL USE ONLY:** It is the position of most practitioners that if a second home is used exclusively for personal use, it does not qualify for a like-kind exchange. Now the question is being raised – Does it qualify for a 1031 exchange if it clearly is being held as an investment property?
6. **NO PERSONAL USE AND NO RENTAL – SECOND HOME HELD VACANT:** This situation does not occur very often. If a second home is held vacant in anticipation of an increase in value, the property would be considered held for investment and should qualify for a like-kind exchange.

Most conservative advisors have stated that if personal use of a vacation property exceeds 14 days or 10% of the days actually rented, whichever is greater, then the property does not qualify for a 1031 like-kind exchange. Others have claimed that additional personal use only moves the property out of the business category, but that it still qualifies as an investment property.

Now in a recent article in the New York Real Estate Journal, Gary Gorman, CPA, author of the book *Exchanging Up!* and a partner in a Colorado exchange firm claims that a recent U.S. tax court case (*Rivera v. Commissioner*) establishes that a vacation home is investment property and thus exchangeable, regardless of personal use or rental activity, if the taxpayer has some expectation that it will appreciate in value.

The position taken by Gorman is going to be a hard sell to CPAs and tax attorneys. If a taxpayer is going to take this position to qualify a vacation home for a 1031 exchange, then they should be certain to consult, in advance, with their CPA or tax advisor.

If, however, this broadened definition of investment property is accepted by the IRS and the tax courts, there will be a significant growth in the number of 1031 exchanges by owners of second homes and vacation properties. For the peace of mind of both taxpayers and their advisors, the IRS needs to resolve this issue by providing definitive guidance as soon as possible.

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