

## 1031 Classification of Second Homes

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Recent articles in *The Wall Street Journal* and *The Washington Post* address the unsettled question of whether “second homes” qualify for an IRC Section 1031 tax deferred like-kind exchange. The articles once again raise the controversial issue of which second home properties can qualify for a like-kind exchange. This is an increasingly important issue since it has been reported that 25 to 35% of current real estate transactions involve a second home, and as we all know, the appreciation and gain on second homes has been steadily increasing.

To qualify for a like-kind exchange, IRC Section 1031 requires that the property be “held for productive use in a trade or business or for investment.” It is clear a property will 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 second home being held for investment?

To examine this issue we need to categorize how second homes are used.

### **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, than 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. No one can give an assurance that the property will qualify for a like-kind exchange if the annual personal use exceeds the Section 280A restrictions.

#### **4. Personal Use-Rental Not in Excess of 14 Days:**

IRC Section 280 permits both principal residence and 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.**

There is no question that if a second home is used exclusively for personal use that it does not qualify for a like-kind exchange.

#### **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.

#### **What is Personal Use?**

The IRS definition of “personal use” is very broad. IRS Tax Topic 415 describes a day of personal use of a dwelling unit as any day that it is used by: 1. The taxpayer or any other person who has an interest in it (co-owner), unless the interest is rented to another owner as his or her main home under a shared equity financing agreement; 2. A member of the taxpayer’s family or a family member of any other person who has an interest in it, unless the family member uses it as his or her main home and pays a fair rental price; 3. Anyone under an agreement that lets the taxpayer use some other dwelling unit; or 4. Anyone at less than fair market rental price. Any day in which the taxpayer does substantially full-time repairs or maintenance, even while others there enjoy themselves, will not be counted as a personal use day.

It is clear that in five of the six categories listed above, a property may or may not qualify for use in a 1031 like-kind exchange. Unfortunately, for most vacation area second home owners, the uncertainty occurs when a property is extensively rented but personal use exceeds the Section 280A 14 day or 10% of actual rental day’s limitation.

The conflicting views and advice set forth in the two recent articles highlight the problem. The most conservative advice given was “for at least two years do not use the (rental) property at all, so that there is no doubt that is a rental property.” The more practical view given in the Wall Street Journal article is to recognize that personal use in excess of the Section 280A tax deduction restriction does not always eliminate a property from qualifying for a Section 1031 exchange. The amount of rental and personal use are important considerations. Also, investment intent, rental efforts and the profit motivation of the taxpayer may also be important factors.

Until the IRS provides more specific guidance, taxpayers should recognize that using a rental property that exceeds the Section 280A limits as a qualifying property in a 1031 exchange could, in the event of an IRS audit, lose the argument that the property was being held for investment purposes.

The more the taxpayer limits personal use and has an extensive rental history, the greater the case for predominant profit motive and demonstrated intent to hold the property for investment. If it is unclear that an exchange property will qualify, the taxpayer should always seek the advice of their CPA or tax advisor.

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