

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 (being converted to Relinquished Property):

- 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 actual 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.

Personal use includes use by the Exchanger’s friends and family that do not pay fair market rent but would not include use by a family member as their primary residence if the family member pays fair market rent. The Revenue Procedure also applies to property being purchased in an exchange, in reverse. That is where the true gift from the IRS exists. Revenue Procedure 2008-16 provides a way to buy a future primary residence, second home or personal vacation property as an exit strategy from investment real estate.

Here is how it works. First, sell your investment property and acquire a future primary residence, second home or personal vacation property as the Replacement Property in a 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 your 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!

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 spoke and gave taxpayers a huge gift which can be used to gain personal benefit from investment properties.

Who said the kinder, gentler IRS disappeared?

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