"Can I Use the Tax-Deferred Exchange Provisions When Buying or Selling a Vacation Home?"

The answer is a qualified "yes" based on a recent Revenue Procedure (Rev. Proc. 2008-16). The general rule under section 1031 of the Internal Revenue Code is that taxpayers can defer gain on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged for property of "like kind" that is to be held for productive use in a trade or business or for investment.

The concept of what constitutes "like kind" property is very broad. For example, vacant land can be exchanged for an apartment building; an office building can be exchanged for a retail shopping center; an industrial building can be exchanged for a hotel; etc. One exception, however, is that personal residences cannot be exchanged and receive tax-deferred exchange treatment because such properties are not held for productive use in a trade or business or for investment.

While personal residences cannot be used in a tax-deferred exchange, the question arose as to the status of exchanging vacation homes. In Rev. Proc. 2008-16, issued in March of this year, the IRS created a safe harbor allowing for tax-deferred exchanges of vacation homes under limited circumstances. The Revenue Procedure provides that the IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment under the following circumstances:

If you are selling a vacation home and want to defer the gain from that sale under section 1031:

1. The taxpayer must have owned the vacation home for at least 24 months immediately before the exchange; and
2. In each of the two 12-month periods preceding the exchange,
    1. The taxpayer must have rented the vacation home to another person or persons at a fair rental for 14 days or more; and
    2. The taxpayer must not have used the vacation home for the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit was rented at a fair rental.

If you have sold other property that would qualify as like kind and want to defer the gain from that sale by buying a vacation home, the following rules

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1. The dwelling unit must be owned by the taxpayer for at least 24 months after the exchange; and
2. In each of the two 12-month periods immediately after the exchange,
    1. The taxpayer must rent the vacation home to another person or persons at a fair rental for 14 days or more, and
    2. The taxpayer's personal use of the vacation home does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The Revenue Procedure also details issues related to use of the vacation home by family members and defines "fair rental" as being determined based on all of the facts and circumstances that exist when the taxpayer enters into the rental agreement.

In summary, the IRS has now clarified the rules for treating vacation homes under the tax-deferred exchange provisions of section 1031. To avoid a challenge by the IRS, taxpayers should strictly adhere to and keep adequate records of their vacation home usage.