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Valuable Information for Real Estate Professionals and their Clients

VACATION HOMES:

“DO THEY QUALIFY FOR TAX DEFERRAL UNDER IRC §1031?”

THE OPPORTUNITY EXISTS FOR SUCCESSFUL VACATION/SECOND HOME §1031 EXCHANGES

Property owners throughout the nation are obtaining the benefit of full reinvestment of equity under Internal Revenue Code §1031. Many investors exchange out of a single family rental, duplex, or any other type of investment property and into a vacation/second home. Many tax/legal advisors believe it is possible to perform an exchange on a vacation property which has no rental history but which still can be considered “held for investment.”

SUPPORT FOR VACATION HOME EXCHANGES?

In Private Letter Ruling (PLR) 8103117, the IRS did allow for tax deferral when a property owner intended to acquire property for personal enjoyment and as an investment. As stated in this PLR, *“...the house and lot you acquire in this trade will be held for the same purposes as the properties exchanged: to provide for personal enjoyment and to make a sound real estate investment.”* Although a PLR only applies to the facts and circumstances in a particular individual's specific situation, it appears, in this instance, that “personal enjoyment” of a property does not prevent a property owner from benefiting from a tax deferred exchange.

EACH INDIVIDUAL CASE MUST BE REVIEWED

Note: There are no regulations, statutes, or court cases which give a definitive answer on the exchange of vacation/2nd homes. Each exchange must be reviewed on a case-by-case basis. To qualify for an exchange, the property owner should be able to support that the property was “held for investment.”

A BRIEF ANALYSIS

IRC Section 1031 provides for the non-recognition of gain on the exchange of property “held for productive use in a trade or business or for investment.” Is a vacation property considered “held for investment?”

Reg. 1.1031(a)-1(b) states in the definition of “like-kind” that “unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.” It appears that even property owners who have never rented their vacation property but can substantiate that they acquired and held the property because they expected it to increase in value (a wise investment decision) may qualify for a §1031 tax deferred exchange. IRC §165 and IRC §280, which address when losses may be deducted on vacation homes, may provide additional guidance to investors.

It is a well known fact that many vacation areas have appreciated significantly and that often property owners purchase properties with the future appreciation in mind. A real estate investor should consult with their own advisors to discuss their specific situation and see if they may qualify for the benefits of a tax deferred exchange.



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