1031 Exchange Rules: Vacation Homes, Primary Residences, and Mixed Use

Under what circumstances can vacation homes, primary residences or mixed use propertiers be used as part of a 1031 exchange? Do they satisfy the requirement that both the relinquished and replacement properties must be held for investment or for use in a business or trade? Does some personal use trump the investment use of the property? This blog is intended to answer these commonly asked questions:

- Under what circumstances can a second home or vacation home constitute relinquished or replacement property for the purposes of a 1031 exchange?
- Can a principal residence be converted into an investment property eligible for 1031 tax deferral upon sale?
- Can a property that has been held for investment be converted to a principal residence and what are the rules when it is sold?
- Can a mixed use property be sold with a personal residence exemption and 1031 exchange deferral?

Rules for Including a Vacation Home in a 1031 Exchange

Historically, determining whether a home that was both rented out and used by its owner could be eligible for 1031 tax deferral was difficult to ascertain. The IRS attempted to provide some definitive guidance regarding some of these questions in the form of Revenue Procedure 2008-16. As the IRS aptly put it:

“The Service recognizes that many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. In the interest of sound tax administration, this revenue procedure provides taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under §1031 even though a taxpayer occasionally uses the dwelling unit for personal purposes.”

This revenue procedure made clear that for a relinquished vacation property to qualify for a 1031 exchange, the property has to be owned by the taxpayer and held as an investment for at least 24 months immediately prior to the exchange. Additionally, within each of the two 12-month periods prior to the sale, the property must have been rented at fair market value to a person for at least 14 days or more, and the taxpayer cannot have used the property personally for the greater of 14 days or 10% of the number of days in the 12-month period that it had been rented.

The requirements for property to qualify as a 1031 replacement property are very similar. The property has to be owned by the taxpayer for at least 24 months immediately after the exchange. Also, within each of the two 12-month periods after the exchange, property must have been rented at fair market value to a person for at least 14 days or more and the taxpayer cannot have used the property personally for the greater of 14 days or 10% of the number of days in the 12-month period that it had been rented. The taxpayer is allowed to use the relinquished or replacement property for additional days if the use is for property maintenance or repair.

Rules for Converting a Personal Residence to a 1031 Exchange-Eligible Property

In many cases, conversion of a personal residence to a property held as an investment or for use in a business or trade "exchange eligible property," as defined above, may still allow a taxpayer to receive a full exemption of gain pursuant to the rules of IRC §121 upon sale of the property. That code section provides for an exclusion of gain of up to $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly upon the sale of a principal residence. There is a requirement that during the five-year period immediately preceding the sale, the taxpayer must have used the property as a principal residence for at least 2 accumulative years.

Even if the property has had principal residence use followed by exchange eligible use, the taxpayer does not necessarily have to do an exchange on the investment/business use of the property if the total gain can be sheltered by the §121 allowed exclusions. So even if during the immediate two years preceding the sale, the property was used as exchange eligible property, the taxpayer may still benefit from the personal residence exclusion. In the event the gain exceeds the maximums allowed for per §121, the taxpayer may still be able to shelter the balance via a 1031 exchange, thus combining the benefits of these two code sections.

Under Revenue Procedure 2008-16 the conversion of the principal residence to an exchange eligible investment property does not disqualify a family member as the tenant. However, the revenue procedure requires that the tenant paid fair market rent and that it was the family member's personal residence, not the family member's vacation home. There are additional rules for the rental of the property by a family member who co-owns the property with the taxpayer.

Should a taxpayer wish to convert the personal residence to exchange eligible property, the taxpayer must have owned the property for the two years immediately prior to the sale and:

1. For each of the years the property must be rented to a person for 14 days or more
2. The taxpayer's personal use has to be limited to no more than 14 days per year or less than 10% of the days per year that property is rented.

Rules for Converting a 1031 Exchange-Eligible Property to a Personal Residence

If the taxpayer's intent, based upon facts and circumstances at the time of the property acquisition was to hold the property as an investment or for use in a business, the subsequent conversion use of the property to use as a principal residence should not otherwise jeopardize the ability to exchange. As an example, a taxpayer may wish to exchange into a rental condominium in Florida and upon retirement relocate from a northern state into the condominium as the principal residence.

If the taxpayer subsequently sells the principal residence, there may be the ability to defer the gain under §121. However there are some limitations to this deferral upon conversion, otherwise taxpayers might convert exchange property into a principal residence property, sell shortly thereafter, and seek §121 deferral. These rules require that the property has to be held for at least five years in total with the period of time the property was held as an exchange property included. The period of time the property was used as an exchange property needs to be backed out of the calculation for the principal residence use deferral. This calculation is made by using the period of time the property was held as an exchange property as the numerator and the period of time the property was held in total as the denominator. The resulting fraction or percentage would be applied to the total gain and the resulting dollar amount would not be eligible for a §121 deferral.

Take the example of a property owned by a taxpayer for seven years prior to sale, three of which were used as an exchange property and four of which were used as the taxpayer's principal residence. Assume that the gain upon sale is $200,000. Dividing the number of three years by seven years x $200,000 results in the amount of $85,714 which is taxable.

1031 Exchanges and Mixed Use Properties

At times, a taxpayer may own a home as the principal residence but part of the property may have been used as an investment or in connection with a business or trade, creating an exchange eligible component. This is known as a mixed use property. An example might by a psychologist who sees patients in a home office. Another example might be a property with a separate house that is rented out. It is quite common for a taxpayer to sell a three flat where the taxpayer uses one unit as the principal residence. In these instances §121 and §1031 can both be used to achieve total deferral.

There is one caveat with exchanges of mixed use properties, which is that on closing statements there is a tendency to give credits for prorated rent and security deposits to the buyer. This causes the net amount of proceeds attributable to each property use component to be reduced proportionately. Technically, those credits only pertain to the exchange eligible portion of the property and should not appear as a credit on the personal residence portion of the sale.

Summary

A variety of circumstances surround property that has been or will be exchange eligible and may also have been used or will be used by the taxpayer as a principal residence or vacation home. Revenue Procedure 2008-16 provides rules regarding vacation homes and exchange eligible property. Likewise, there are rules under IRC §121 for converting exchange property into a personal residence and vice-versa. Properties that have both a principal residence component as well as an exchange-eligible one can benefit by both deferral sections, but care should be taken to do proper accounting so that buyer credits affect the exchange eligible portion of the sale only.