



Robert W. Wood

THE TAX LAWYER

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Sell Your House Or Vacation Home Tax-Free In A 1031 Exchange?

In [7 Key Rules About 1031 Exchanges — Before They're Repealed](#), I noted the proposal in Congress to repeal this storied section of the tax code. Repeal is not likely in the short term, but you still might want to take advantage of this rule while you can. A 1031 exchange is a swap of one business or investment asset for another without tax. There's no limit on how many times you can do it, so you can keep rolling over your gain.

The odds of finding someone with the property you want, who wants your property, are slim. So most exchanges have three parties. A middleman holds the cash after you sell. The middleman then buys the replacement property for you. But there are time limits and details to be observed.

Remember, 1031 is for investment and business property, not personal. You can't swap your primary residence for another. But, aren't vacation homes investments? Also, can't you *convert* your personal residence to "investment" and *then* do a 1031? Maybe.



(Photo credit: Wikipedia)

First, note the primary residence tax benefit on sale. You can sell your primary residence and, combined with your spouse, shield \$500,000 in capital gain, as long as you've lived there for two years out of the past five. But this break isn't available for your second or vacation home.

You might have heard tales of taxpayers who used a 1031 to swap one vacation home for another, perhaps even for a house where they want to retire? One question is whether the 1031 was legit, but it can be. Later, you hear, the couple moved into the new property themselves and made it their primary residence. Eventually, they use the \$500,000 capital gain exclusion! Pretty slick.

Here's another example. You stop using your beach house, rent it out for six months or a year, and then exchange it for other real estate. If you actually get a tenant and conduct yourself in a businesslike way, you've probably converted the house to investment property. That should make your 1031 exchange OK.

But if you merely *hold it out* for rent but never actually have tenants, it's probably not. The facts will be key, as will the timing. The more time that elapses after you convert the property's use, the better. Although there is no absolute standard, anything less than six months of bona fide rental use is probably not enough. A year would be better.

If you want to use the property you received in the 1031 exchange as your new second or primary home, don't move in right away. In 2008, the IRS issued a safe harbor rule. IRS said it would not challenge whether a replacement dwelling qualified as investment property for purposes of a 1031.

To meet that safe harbor, in each of the two 12-month periods immediately after the exchange:

- You must rent the dwelling unit to another person for a fair rental for 14 days or more; and
- Your personal use can't exceed the greater of 14 days or 10% of the number of days during the 12-month period that you rent it out at a fair rental.

After successfully swapping one vacation/investment property for another, you can't immediately convert it to your primary home and take advantage of the \$500,000 exclusion. If you acquire property in a 1031 exchange and later attempt to sell it as your principal residence, the exclusion does not apply for five years. You must wait five years after the 1031 exchange to qualify for the primary residence tax break, not the usual two years.

Is all of this maneuvering worth it? It may not be depending on the numbers. And factor in the risk that the IRS may disagree with some or all of what you've done. It's worth noting that you can probably do a simple 1031 exchange without a lawyer, just using a 1031 intermediary firm. But if you have complex facts, a mortgage on one or both sides of the transaction, or questions like the ones raised here, consider getting some independent professional help.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.