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Vacation Homes, Second Homes and Timeshares—Can They Be Exchanged?

Capital gains deferral under Section 1031 is limited to property “held for investment” or for “productive use in a trade or business”. Some tax practitioners have opined that vacation or second homes rented out for most of the year with little or no personal use will qualify as “held for investment” under Section 1031, while others believe that as long as the taxpayer’s personal use does not exceed the limitations set forth under IRC Section 280A, the property will qualify¹.

Does failure to rent disqualify a property from Section 1031 deferral?

Property held solely for appreciation qualifies as “held for investment” under Section 1031. The Treasury Regulations specifically define “held for investment” as follows: 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. Thus, failure to rent property is clearly not fatal to its characterization as “held for investment” under Section 1031.

Does personal use disqualify a property from Section 1031 deferral?

There is no definitive answer. In Private Letter Ruling 8103117, the taxpayer owned two properties they intended to exchange. One property was intermittently rented out for a period of time and then for several years thereafter not rented at all. The second was purchased by them solely for personal enjoyment of the community and to make a sound real estate investment. The replacement property acquired in the exchange was for “personal enjoyment of the community” and “to make a sound real estate investment”. Notwithstanding the personal use by the taxpayer, the IRS held that no gain would be recognized in the exchange because both the relinquished and replacement properties were essentially “investment” properties. Unfortunately, the IRS provided no indication of when and how much personal use would be disregarded under similar circumstances.

Therefore, based on the foregoing, when a second/vacation home is never rented and the personal use is minor, it may qualify under Section 1031.

Timeshares. A timeshare is generally characterized in one of two ways:

(1) the right to use a property for a

specified period of time pursuant to a contractual timeshare agreement; or (2) actual co-ownership of a fractional fee interest in a property – having the right to occupy the property for a period of time designated by agreement.

Since both types of arrangements are almost always acquired and used for a taxpayer’s personal use, it is difficult, in most cases, to argue for qualification under Section 1031 as property held “for investment”. There may, however, be certain situations when a fractional ownership interest is acquired and rented to others purely for a profit. Under those circumstances, a timeshare may, in fact, qualify under Section 1031.

Therefore, although it appears that second/vacation homes and timeshares may qualify in certain circumstances under Section 1031, because of the lack of legal precedence for this proposition, taxpayers should be cautious in pursuing these transactions – except upon the advice of their tax advisor.

¹ Under Section 280A property is treated as business property (and thus depreciation deductions can be taken) or investment property (allowing for losses on a sale) so long as the taxpayer’s personal use does not exceed the greater of 14 days or 10% of the number of days the property is rented at fair market value to others.



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