

SECOND HOMES & 1031 EXCHANGES

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Owners of second homes looking to save taxes by entering into a 1031 exchange face some very strict IRS regulations. If the second home was never rented out, the IRS will not allow a 1031 exchange. Significant time requirements exist for the owner to convert their second home into rental property prior to any sale to take advantage of a 1031 tax deferred exchange.

A safe strategy is to convert the second home into an investment property and rent out the property at fair market value for two years prior to the sale and exchange of the property. Alternatively, the owner could rent out their second home for a minimum of 14 days at fair market value and limit their own personal use to 14 days per year for the two years prior to the sale of the property or 10 percent of the number of days that the property is rented at fair market value during each year.

The IRS has very specific definitions regarding personal use if for any part of a day the property is utilized by the owner. This includes the owner who has an interest in the second home or vacation property as a tenant-in-common interest. Furthermore, use by any member of the owner's family counts as personal use days unless the second home or vacation property is rented out to those family members as a full time principal residence at a fair market rent.

Another IRS requirement specifies that if the owner rents out the vacation or second home property at less than fair market value, the days rented will be considered personal use days. Lastly, an additional rule defines that any use by the owner who uses the property under an arrangement which enables them to use some other property is considered personal use. For example, trading a second

home or vacation property use whether or not a rental is not allowed. Per the IRS, the "fair market rent" is determined based on all of the facts and circumstances that exist when the rental agreement is entered into, and all rights and obligations of the parties to the rental agreement are taken into account.

Some taxpayer usage is not considered as personal use if the taxpayer is engaged in repair, upkeep and annual maintenance on a substantially full time basis for any day. The taxpayer must be ready to prove that the actual work was done.

In summary, an owner can take their second home or a vacation home and rent it for 14 days per year at fair market value for two years and then exchange out of it. Remember that the owner's personal use must be limited during these two years to 14 days a year as well. The other alternative for the owner is to rent the property at fair market value as a principal residence to either a related or unrelated third party for two or more years prior to the 1031 exchange.

With so many intricate IRS rules regarding vacation and second home properties, always check with your tax advisor before engaging in any 1031 exchange or call the knowledgeable experts at Bankers Escrow Corp. For more 1031 Exchange information check out: WWW.BANKERSESCROW.COM

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