What to know about 1031 exchanges for investment properties

What is a 1031 exchange?

Put simply, a 1031 exchange is IRS-speak for swapping one income property for another. It’s a unique tax benefit—with some specific requirements—that’s becoming more common in real estate deals as property owners increasingly look to trade up for vacation homes that they also intend to rent out to paying guests.

In 1031 exchanges (or "swaps"), you’re changing your investment in the eyes of the IRS, transferring the gain from a relinquished property to newer property while allowing your investment to grow tax deferred. If your home qualifies for a 1031 exchange, you’ll defer paying taxes on the sale until you sell many years later.

Why should I do a 1031 exchange on my investment property?

A 1031 exchange is a way to increase the value of your investments. Choose a 1031 exchange to upgrade your investment to something better, like a vacation rental home. Before you sell your income property, first see if you qualify for a 1031 exchange.

What are 1031 exchange rules?

Here are seven primary 1031 exchange rules and requirements to keep in mind:

1. The investment property being sold and the property being acquired must be similar, or like-kind.
2. 1031 exchanges only apply to business or investment properties, not personal property.
3. The replacement property must be of equal or greater value.
4. For the exchange to be completely tax-free, you can't receive "boot." Partial exchanges of a newer, but lesser value property, are allowed. However, you will have to pay the normal capital gains tax liabilities on the difference (otherwise known as the "boot").
5. The titleholders and tax returns of both the old property and newly acquired property must remain the same.
6. Delayed exchanges are allowed. After closing on your first property, you have 45 days to identify up to three potential like-kind properties as a replacement.
7. Your replacement property must be received and exchanged within 180 days after your original property is sold.

What qualifies as a 1031 exchange?

Only business or investment properties are eligible for swapping as a 1031 exchange. This includes vacant lots, apartment buildings, commercial properties, and even single-family residences you rent out to tenants. A property you use solely for personal use, such as your primary residence, does not qualify.

Through a safe harbor called the IRS Revenue Procedure 2008-16, the IRS takes the position that a property qualifies as an investment as long as you follow all the right procedures for swapping like-kind exchanges.

Can I buy a vacation home with a 1031 exchange?

Rolling the proceeds from the sale of an investment property into a vacation rental enables you to increase the value of your investment while acquiring property you can enjoy and be proud of. So long as during the first two 12-month periods after the exchange, you rent the property for more than 14 days per year, and you use it for fewer than 14 days per year—and no more than 10% of the nights rented—you can invest the proceeds of a like-kind exchange into a vacation rental home.

Are there any rules around rates and fair market value?

When renting a vacation home you purchased as part of a 1031 exchange, remember that your rates must be at fair market value. No renting it to your sister for $1 per night—that would count as personal use unless she’s repairing the roof. If you’re not currently meeting the 10% requirement—say, 140 nights of rentals for your 14 nights of personal use—Vacasa can help. We’ll market your property on popular vacation rental channels, such as Airbnb, Booking.com, and Vrbo. Plus, we automatically set optimal rates using our dynamic pricing technology.

Can I buy a retirement home with a 1031 exchange?

Say you own an aging fourplex, and you'd rather own an oceanfront home you can retire to one day. If you simply sell the fourplex, you'd pay capital gains on any appreciation, as well as the depreciation recapture. Alternatively, you could use a 1031 exchange to purchase the perfect retirement home. In the first two years, your personal usage cannot exceed 14 days, and you'll need to rent it for 10 times the number of personal use nights: at least 14 days per year.

Converting rental property acquired in a 1031 exchange to a primary residence blends Section 1031 with Section 121 that provides the $250,000/$500,000 exclusions. To benefit from Section 121, the converted property must be held for five years with the first two as a rental also known as non qualified use. At the end of five years, 3/5 of the gain is excluded given the $250,000 or $500,000 limits in Section 121.

Can I sell a vacation home through a 1031 exchange?

You can sell your vacation home through a 1031 exchange as long as you rented it for more than 14 days per year and your personal use was no more than 14 days per year (and less than 10% of the total nights rented) over the two years leading up to the sale. Not yet renting your second home? Contact Vacasa to start the clock today. We're the largest vacation rental management company in the U.S., which means we most likely operate in your area (and if we don't, you can bet we'll be there soon). Supported by a modern global operations system, our local experts take care of everything from permitting to cleaning. Meanwhile, our specialists at headquarters use industry-leading technology to deliver superior financial performance.

What are the benefits of a 1031 exchange for vacation rentals?

Earn "free" nights while working on your home (and maximizing return on the rest)

Do you enjoy working on homes, or have plans to make improvements? Any days you spend working on the vacation rental property don't count against the 14-day limit. That means, you can stay at your new beach house whenever you want as long as you're putting in some elbow grease to improve its value.

Eventually you can stay as often (or as little) as you like

After two years of capping your personal stays at your vacation rental to 14 days, and renting it out to guests for 10 times as much as you stay there, then you are free to stay as often as you'd like without further requirements.

However, if you continue to rent out your vacation home to paying guests for at least 14 days a year, you may be eligible to write off most of your rental expenses to reduce your taxes.

You can do a 1031 exchange over and over to defer taxes

There are currently no limits to how many times you can conduct a 1031 exchange. You can roll over the capitol gains from one investment property to another, and another. Even if each swap produces a profit, you can defer paying taxes until you sell for cash.

Swapping your income property for a vacation rental home as part of a 1031 exchange is a personally rewarding way to level up your investment. You'll also likely benefit from substantial appreciation, as many vacation markets are inherently constrained. After all, they aren't building more coastline to fit more beach houses and condos.

If you're flexible as to where you'd like to invest your proceeds, see our list of the top 25 places to invest in a vacation rental. Organized by cap rate, this curated collection features a range of the best established and up-and-coming markets for great returns. Regardless of where you buy, our vacation rental real estate network can help you find the perfect vacation rental property while navigating local regulations.