

SECOND HOMES: INVESTMENT VERSUS RESIDENCE INFORMATION

What is “like kind” property? In a 1031 exchange, “like kind” refers to any property used for investment purposes. For example, a primary or secondary residence primarily for personal use and enjoyment is not considered “like kind” under section 1031. However, if a second home is used primarily for income and investment purposes, it may be eligible for a 1031 exchange.

Is a vacation home an investment? If you can prove that a vacation home is an investment, it may be eligible. Things to look for are: the property is reported on a Schedule E tax form; loan documents reflect investment property; listed as an investment with financial planner, CPA, or tax/estate attorney; investor research and due diligence, like estimates of cash flow, historical performance, etc; correspondence with other professionals, such as appraisers and property managers.

It is not investment property if: it is for purely personal use; used by immediate family; used by relatives at nominal rent (must be at fair market value to avoid personal uses accruing to taxpayer). The taxpayer should consult with a CPA or tax counsel to determine whether a property is held as an investment.

How is the Primary Holding Purpose determined? Consider whether you are anticipating and seeking cash flow, and therefore treating the property as a rental property. Are you seeking appreciation? Relaxation? A combination? Remember that significant personal use of a property can be deemed to override the “held for investment” criteria in the eyes of the IRS. Analysis is driven by facts and circumstances. Visits primarily to work on the property do not necessarily constitute personal use; visits and discussions with on-site management may be part of property operation. Remember that personal pleasure and recreation elements can easily outweigh investment elements.

What if my property is Split Use, part personal use and part investment? Normally, Split Use- as in a combination property with an office space- is based on square foot or number of rooms analysis. A working farm residence is based on land area plus replacement cost analysis for the home. A duplex or triplex is based on unit or bedroom count. Split Use can also be measured over time, as in a second home which is 6 months residence, 6 months rental. Sale of a Split Use property can be bifurcated to a 1031 and a Schedule D Long Term Capital Gain transaction.

How can a second home be converted to an investment? IRS law implies approval of the conversion process, for what is deemed a “held investment.” There is no specific length of time designated to establish a “held investment.” Some advisors suggest more than one year, others suggest crossing two or three tax years. To be viewed as an investment, look at indicators such as: is the property run by a management company, or otherwise operated in a professional manner? Is sales tax on its income being paid? Are there marketing materials in use? What is the length of the rental continuum?

How can a second home be converted to a residence? Conversion of investment to residence from the sale of property acquired through 1031 exchange requires a 5 year hold to be eligible for the residence exclusion. During those 5 years, pay attention to homestead exemption; address on page one of the 1040 tax return; voter registration address; children enrolled in the local school; church and civic memberships; drivers license and auto registration.

Please Note: 1031 Qualified Intermediaries do not determine, validate, or endorse a taxpayer’s use of a property. They cannot approve or disprove viability. You may seek a private letter ruling from the IRS for concrete answers; consider the time and cost.