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Valuable Information for Real Estate Professionals and their Clients

Establishing Intent on Vacation Homes

DO VACATION HOMES QUALIFY UNDER IRC §1031?

Whether or not vacation homes, or second homes, qualify as "held for investment" under IRC §1031 is a contested question among professionals within the 1031 exchange community. The regulations do provide that unproductive real estate held by a non-dealer for future use or future appreciation is considered held for investment. Although, past court cases have demonstrated that a vacation home most likely will not qualify as held for investment if there is substantial personal use.

DOES THE IRS DEFINE INVESTMENT?

The attempt to define property as held primarily for investment purposes is a matter of fact and intent. For purposes of Section 1031, property may be held for investment purposes if losses from the sale or exchange are deductible. Section 280A governs the allowance of deductions from a dwelling unit that the taxpayer utilizes as a residence. These deductions are limited with respect to the use of the dwelling unit by the taxpayer during the taxable year. Section 280A(d) states that a taxpayer uses the unit as a residence if the taxpayer uses the unit for personal purposes for a number of days which exceeds the greater of 14 days, or 10% of the number of days during the year for which the dwelling unit is rented for fair market value.

Section 280A also provides that "the Secretary shall prescribe regulations with respect to the circumstances under which use of the unit for repairs and annual maintenance will not constitute personal use under this paragraph, except that if the taxpayer is engaged in repair and maintenance on a substantially full-time bases for any day, such authority shall not allow the Secretary to treat a dwelling unit as being used for personal use by the taxpayer on such day merely because other individuals who are on the premises on such day are not so engaged.

If Section 280A does not apply to determine whether a vacation home is held for investment, then you may look to Section165. Section 165 generally states that losses may be deducted if the transaction was entered into for a profit. The predominant motive, and not the secondary, must be a profitable sale.

SUGGESTIONS THAT MAY HELP PROVE INTENT

- Any maintenance or updates that are done to the property should be claimed as investment expenses and deducted under Section 212.
- The mortgage interest deduction should be deducted as an investment interest rather than home mortgage interest under Section 163.
- Claim depreciation connected with the property.
- Make the property available for rent, even if it does not get rented. Advertise to show that there is an intent and effort to get the property rented. Consider renting out to friends for fair market value.
- Keep documentation on file that shows trends in the property appreciation year after year.
- Write a letter to your CPA stating intent to hold the property as an investment, and for appreciation.