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When is your vacation home investment property?

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Owners enjoy many of the "home away from home" comforts in their vacation property, but when it comes time to sell, they do not benefit from the same tax exclusions as that of a primary residence sale. Capital gains and possibly recapture taxes apply. Furthermore, even though you consider your second home an "investment," have maybe even put cash or sweat equity into it, holding the property solely for personal use disqualifies it from tax deferral via a 1031 exchange. With no proven business use (i.e. rentals), the IRS reasons that "holding this property with the hope of future gain" is simply not enough to qualify the property as "held for investment" under the §1031 Tax Code.

Investors inevitably ask: "How long do I have to rent out the property? How much can I use it?" In 2008, the IRS answered: For a "dwelling unit" to qualify as property held for investment purposes and eligible for 1031 exchange treatment, the taxpayer must have:

- * Owned it for 24 months immediately before the sale/exchange, and
- * Rented it at fair market rental for 14 days or more within each of the past two 12-month periods the Exchanger, and
- * Restricted his/her personal use to not exceed the greater of 14 days or 10% of the total days rented within each of those 12-month periods.

Going forward, replacement property must meet the same criteria as above, and the exchange itself must meet all other §1031 requirements.

Planning ahead is crucial. Turning your investment into "investment property" offers a two-fold advantage: generate income now by converting personal use property to a qualified rental and be eligible for capital gains and depreciation recapture tax savings in the not-so-distant future!

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