



The Second Home - A Red-Haired Stepchild for Tax Purposes

By Fran Coet
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In the world of income tax planning, the second home is much like a red-haired stepchild – neither a principal residence eligible for preferential treatment on sale, nor an investment property eligible for certain other tax preferential treatments. Sometimes, in fact, the second home is treated as a hybrid – sometimes used as a second home for personal purposes, and sometimes treated as a rental property, with the sheltering that depreciation and business expenses brings to the owner’s tax return.

In this economic climate, increasing numbers of second-home owners are looking to unload their asset. And while the second home has diminished in popularity, plenty of people still dream of that mountain or beachfront luxury, and they need to know the tax consequences before they buy.



If a principal residence is sold at a gain, there is an exclusion of up to \$500,000 for married couples filing jointly, and up to \$250,000 for unmarried individuals. To qualify as a principal residence, the structure must be owned by the taxpayer and occupied by the taxpayer as the his primary residence for two of the previous five years immediately prior to its sale. In addition, the owner must not have claimed the exclusion on the sale of a principal residence that occurred during the past two tax years immediately prior to the sale. Some exceptions apply – if there is an employer-caused move, or the move from the structure is due to unforeseen circumstances, such as health issues. Then the two-year, own-and-occupy exclusion is prorated, based upon the number of months of actual ownership and occupancy.

In the case of trade or business or investment property (under which rental property applies), a generous provision under Internal Revenue Code Section 1031 allows the seller of the property to defer indefinitely the gain on the sale of the investment property, provided that “like kind” property is acquired within very rigid time constraints. Code Section 1031 does not apply to a second home if it has been solely for personal use.

This issue came to the attention of the Internal Revenue Service in a recent court case (Barry E. Moore, et ux. v. Commissioner, TC Memo 2007-134, Code Sections 1031; 212). The Moores owned a second home on a lake (Clark Hill) in Georgia that was clearly a second home. After holding the property for a number of years, they sold property at a substantial gain. The Moores then acquired a replacement piece of real property on another lake site closer to their home, and utilized Section 1031 to defer taxation of the gain on the Clark Hill property.

The Clark Hill property had never been rented, nor been offered to rent, and had been used solely by the Moores as a second home. They deducted the mortgage interest paid on the mortgage as home mortgage interest. Although Mr. Moore told the court that he had hoped that the Clark Hill property would appreciate while he held it, the court responded that “mere hope ... (of appreciation could) not establish an investment intent if the taxpayer uses the property as a residence.” The Moores were forced

to pay tax on the gain realized on the sale of the Clark Hill property.

On Feb. 15, 2008, the IRS issued Rev. Proc. 2008-16 (2008-10 IRB 547), which provides a safe harbor under which it will not challenge whether a dwelling unit qualifies for deferring gain under Section 1031. If a taxpayer intends for a property to be available for Section 1031 deferral, the property must be owned by the taxpayer at least two years immediately before the exchange, and, within that same time period, the taxpayer 1) must rent the dwelling unit to another person or persons at fair rental for 14 days or more, and 2) the taxpayer's personal use of the dwelling unit cannot exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair market value. These rules apply to sales occurring after March 10, 2008.

There are obvious planning opportunities for second home properties, but they are not quick fixes. Any real estate professional assisting the owners of such second home properties must inform the seller of the tax consequences of the transaction, or certainly should be referring the seller to their tax advisors for suggestions to mitigate or defer the tax consequences on sale.

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