



## Breaking News in the Real Estate Industry

April 2008

### IRS Rules on Vacation Homes

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President

During the 1st quarter 2008, the Internal Revenue Service (IRS) published the Internal Revenue Procedure 2008-16 (Procedure) that provides a safe harbor to taxpayers under which the IRS will not challenge whether a **dwelling unit**<sup>1</sup> qualifies as

property held for productive use in a trade or business or for investment for purposes of completing a like-kind capital gains tax deferred exchange under Section 1031 of the Internal Revenue Code (i.e., 1031 Exchange). In the past, the tax courts had held that properties such as vacation homes, that were held for personal use with the mere hope or expectation that the property may be sold at a gain could not establish an investment intent if the taxpayer used the property as a residence.

This safe harbor Procedure provides useful guidance on the characterization of vacation property if certain ownership and use requirements are met. It is also helpful for planning purposes such as the conversion of a principal residence into a qualifying relinquished property.

In a nutshell, when completing a 1031 Exchange both the relinquished and replacement properties are owned by the taxpayer for at least 24 months immediately prior to the exchange and at least 24 months immediately after the exchange (qualifying use periods); **AND** within each of the two 12 month periods constituting the qualifying period, the taxpayer must: i) rent the property to another person(s) at fair market value for 14 or more days; **AND** ii) the taxpayers personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair market value rent.

<sup>1</sup>Dwelling unit—any real property improved with a house, apartment, condominium or similar improvement that provides basic living accommodations including a sleeping space, bathroom and cooking facilities, a residential property.

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### Typical TIC Investor

The landscape of the tenant-in-common<sup>1</sup> (TIC) investor is increasing. More and more investors choose TICs as a way to passive income without the headaches—tenants, turnover, termites, trash and toilets—of property and asset management associated with traditional real estate assets. Portfolio diversification across asset types and markets are also a driving force, more so in light of today’s volatile markets.

TIC are also an efficient tool in completing 1031 Exchanges. These investments allow the investor to closely match equity and debt ratios of the relinquished property with those of the replacement property, thus, minimizing boot<sup>2</sup>. As TICs come with financing and management in place, and appraisals, inspections, market studies and other due diligence work completed, they are easier to identify during the 45-day identification period prescribed by the 1031 Exchange statutes, and increase the investor’s likelihood of completing the Exchange.

The majority of TIC owners do not want to pay the capital gains taxes associated with the sale of their long-held property, but would rather put that “lazy” equity back to work. The multiplier effect of injecting that equity into the TIC rather than paying the taxes, many times is translated into higher cash flows and potential for increased appreciation and wealth.

TICs are not for everyone. Investors must be willing to let go of the day-to-day real estate management, control and operations. Investors must understand and be familiar with the typical real estate risks — market conditions, financing, cash flow interruptions, closing and other risks associated with owning any real property.

TICs are only available to accredited investors, which is: i) a natural person who had an individual income in excess of \$200K in cash of the two most recent years, or joint income with that person’s spouse in excess of \$300K in each of those years and has a reasonable expectation of reaching the same income level in the current year; or ii) a natural persons with 1 million dollars in net worth; or iii) an entity with 5 million dollars in total assets.

TICs do come at a premium—the cost of packaging the investment is added to the sales price of the offering. TIC owners share ownership with 34 other investors. Some investors prefer to wholly own their own real estate. So the questions is: Am I ready for a management-free lifestyle?

<sup>1</sup>TIC investments—undivided, fractionalized ownership of large, institutional-grade properties.  
<sup>2</sup>Boot—additional monies not utilized in a 1031 exchange. Create a taxable event to taxpayers. May be in the form of cash, mortgage or unqualified closing costs.

### Sponsors Make All the Difference

The old adage that an investor makes his money up front upon the purchase of the property implies that the amount of due diligence work completed is directly proportional to the amount of profit and success of the investment on the back end. This is partially true.

Another real estate “principle” heard over the years—location, location, location—implies that every well situated asset will succeed. A TIC investment, on the other hand, is more than its location and more than the due diligence work completed by the sponsor who acquired the asset and packaged the investment for sale.

Evaluation of a TIC investment should be divided into two categories: evaluation of the real estate asset, and evaluation of the sponsor who, in most cases, stays with the investment/investors as asset and/or property managers for the life cycle of the investment.

In evaluating the asset, particular attention should be paid to the quality of the structure, the tenants and quality of income, market and other economic trends, terms of the financing, the private placement memorandum (PPM-similar to a prospectus), etc.

Evaluating the sponsor requires looking at: management of the investors expectations before and during the hold period; the transparency and efficacy of its investor communications and relations; reporting practices; financial strength; commitment to the investment; appropriate representation of a property during the sales process; etc. Additional factors in evaluating the sponsor includes: stability; managerial experience; prior performance; company structure; and the ability to resolve concerns and discover new issues.

Performing sponsor visits is a good way to determine if a sponsor has these important characteristics. Visits many times provide answers to any remaining unanswered questions that may not be available or apparent in third party reports.

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