

Vacation Homes and Tax-Free Income

By Phillip J. Benoit, CPA

Many taxpayers own more than one home. Itemized deductions for mortgage interest and real estate taxes are allowed a home-owning taxpayer for up to two residences: a principal residence and "one other residence." The "other residence" is most often a vacation/weekend home that is not rented out at any time during the year.

What are the consequences to a taxpayer who rents out a vacation home? As always with taxes, it depends.

The property must be rented at fair market value to qualify the taxpayer for rental property deductions. There is a minor exception for family members and relatives. Also, generally, time-shares and co-owned homes are guided by the same rules discussed below.

The Internal Revenue Code classifies rentals into three different categories: Personal Residence (not to be confused with Principal Residence, one's primary home), Mixed Use Home and Rental Property. Each is discussed below.

Personal Residence, Rented Fewer than 15 Days

Generally, *all* income is reportable by taxpayers on their income tax returns. However, the Internal Revenue Code offers an exception to the reporting of rental income if a home is rented for 14 days or less. To the taxpayer's advantage, rental income for this period does *not* have to be reported on the income tax return. Yes, it is tax-free income.

Of course, since this is tax-free income no deductions for operating costs are allowed, but mortgage interest and real estate taxes remain deductible as itemized deductions.

Mixed Use, Rented More than 14 Days

Once a property is rented for more than 14 days and the taxpayer continues to use the property for personal use, the property becomes of "mixed use" and the number of "personal use" days becomes important for tax treatment.

If the taxpayer uses the property for personal purposes for more than the greater of (a) 14 days or (b) 10% of the number of days during the year in which the home is rented, then the expenses must be apportioned in order to be deducted against rental income. For example, if the taxpayer occupies the home for 40 days and rents it out for 102 days the taxpayer exceeds both tests and the property becomes a "mixed use" vacation home. If, however, the taxpayer uses the house for 9 days and rents it out for 102 days, it would be "Rental Property," discussed below.

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Apportioned expenses are generally of four types: mortgage interest, real estate taxes, casualty losses and operating expenses (including depreciation). The Internal Revenue Code requires that all expenses must be apportioned before deduction from rental income. The apportioned amount of the first three categories must first be deducted from rental income. If these deductions create a net rental loss, the loss is deductible but no further deductions are allowed. If, after deducting the first three types of expenses there is net income,



who's who

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operating expenses are then deducted, up to net income, resulting in zero as net income/loss. Any excess operating expenses may be carried forward to the following year. Of course, if after deducting all four categories of expenses there is net rental income, it will be included on the taxpayer's income tax return.

Taxpayers often ask if taxes can be minimized by fully deducting the first three categories as itemized deductions against their other income (as is done in the case of a "Personal Residence") and deducting only operating expenses against rental income. The Internal Revenue Code forbids this approach.

Rental Property

All rental income for property that is rented for the entire year or is available for year-round rental must be reported on the personal income tax return of the owner. Mortgage interest, real estate taxes, depreciation, common charges for homeowner's associations or condo/co-ops and all operating expenses (insurance, rental commissions, etc.), are deductible against this income. Be aware that even though the property may have only been rented for a few months, as long as the appropriate business measures were taken to rent the property for the longest periods possible, all deductions are allowed. If the final outcome of these deductions is a net loss, it can be deducted on the tax return, subject to the passive activity loss rules. Basically stated, taxpayers are allowed a deduction for up to \$25,000 of rental activity loss, which is considered a passive activity loss. This deduction is limited once a taxpayer reaches adjusted gross income of \$100,000 and is eliminated if adjusted gross income reaches \$150,000. Special rules apply to real estate professionals. Obviously, these rules are complex, and require the advice of a tax expert. ▲

***Helpful Tips:** Before purchasing a second home with the idea that it will result in tax savings, it is wise to "run the numbers" to determine if savings expectations are realistic. Also, if a taxpayer owns two residences and purchases a third, the mortgage interest is considered personal interest and is not deductible.*

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