HOW TO MAKE THE BEST TAX USE OF A VACATION HOME

An improving economy and stock market doubtless will result in improved vacation home rental income for owners in choice locations, and, possibly, a renewed interest in owning properties which can generate some rental income while providing the family with a place to rest and relax. However, a taxpayer who owns a vacation home, or is thinking of buying one, should be aware the tax aspects of using and renting a vacation home can be complicated. This Hot Topic reviews the special tax rules which apply to vacation homes and suggests some planning moves.

- **Tax-free vacation home income**

  A taxpayer who rents his vacation home for less than 15 days during the year doesn't report rental income and can't claim offsetting vacation home deductions. This one-of-a-kind tax break can be a windfall for those who own properties in prime vacation spots or in other sought-after areas where even a few rental days can bring in substantial dollars (e.g., the city where a national party's nominating convention takes place, or a location near a prime sporting event, like the U.S. Open).

- **Vacation home used as a residence**

  A vacation home is treated as used as a residence during a tax year if personal use exceeds the greater of 14 days or 10% of the days the property is rented to others during the year and rental use exceeds 14 days during the year. Although the property is considered to be a residence, the owner still must treat the rental portion of the vacation home separately from the personal portion.

  - **Rental portion**

    Rentals are included in income on Schedule E, but may be offset with deductions for the rent-related portions of expenses such as utilities, maintenance, upkeep, mortgage interest, real estate taxes and insurance. The owner also may claim a depreciation deduction relating to the rental use. However, deductions can't exceed rental income less:

    < Deductions related to the rental activity itself, such as advertising and broker's commissions.

    Note: During the year, an owner may have to travel to his vacation home in connection with its rental. For example, he may have to drive out to the home to meet a prospective tenant, or to arrange for the home to be cleaned up or repaired before the rental period. These types of expenses should be deductible (e.g., at the rate of 37.5¢ per mile in 2004 for driving) along with other rental-related costs.

    < Deductions (such as interest and real estate taxes) allocable to the rental use which would be deductible whether or not the vacation home was rented out.

Excess expenses are carried forward and may be used in a future year when there's additional rental income. Because the vacation home owner's rental deductions for the year are effectively restricted, he doesn't have to worry about the passive loss rules for that year; they specifically don't apply in this situation.

- **Personal portion**

  The owner deducts on Schedule A the real estate taxes and mortgage interest allocable to personal use of the home. Because personal use exceeds the greater of 14 days or 10% of the days it is rented out during the year, the vacation home is a qualified residence for purposes of the mortgage interest deduction. Assuming the taxpayer doesn't own another vacation home, and meets the other rules for deducting qualified residence interest, he can fully deduct the personal-use portion of the year's mortgage interest.

- **Allocating expenses**

  The IRS says <u>all</u> expenses are apportioned between rental and personal use based on the number of days used for each purpose. However, the Tax Court, the Ninth and the Tenth Circuits maintain interest and taxes are allocated to rental use based on the ratio of actual rental days to total calendar days. All other expenses (e.g., utilities and maintenance) are allocated based on the ratio of rental days to total days of use.

  Note: The courts' approach can yield bigger overall deductions for the vacation home owner. For example, if a home is rented three months a year and used by the owner for vacations for one month a year, IRS's allocation of interest and taxes is based on the period of actual occupancy (four months), and the amount of rental income against which other expenses can be deducted is reduced by 3/4 of the interest and taxes. But if interest and taxes are allocated on the basis of an entire year (as permitted by the Tax Court, Ninth and Tenth Circuits), rental income is reduced by only 1/4 of the interest and taxes (3 months/12 months), with the result being a larger deduction of other rental expenses under the limitation.

■ Vacation home used as rental property

A vacation home is treated primarily as rental property for a tax year in which personal use of the unit doesn't exceed the lesser of 14 days or 10% of the days the property is rented out during the year at a fair rental. In this situation, the owner's deductions are restricted by the passive loss rules, not by the vacation home rules.

- **Rental portion**

  As rental property, the income and deductions from the vacation home generally are automatically treated as passive in nature (unless the owner qualifies under the Code for material participation exception for qualifying real estate professionals). If deductions allocable to the rental portion exceed rental income, the loss generally can only offset other passive income until the property is disposed of. However, if the owner actively participates in the vacation home rental venture and AGI doesn't exceed $100,000, he can shelter non-passive income with up to $25,000 of losses from active-participation real estate rental activities, including the vacation home rental enterprise. The $25,000 allowance starts to phase out when AGI exceeds $100,000, and disappears completely when AGI reaches $150,000.

The active participation standard, which is less stringent than the material participation requirement, can be satisfied without regular, continuous and substantial involvement in operations as long as the taxpayer participates in a significant way by, for example, making management decisions or arranging for others to provide services. Management decisions which are relevant in determining whether a taxpayer actively participates include approving new tenants, deciding on rental terms, approving capital or repair expenditures and other similar decisions. The $25,000 allowance won't be available if a management or rental agent handles all aspects of renting the unit and maintaining it.

The rules are different if the property is not treated as a rental activity. For example, if the average period of tenant use is seven days or less, the property will not be treated as rental property. Thus, there is no $25,000 rental real estate allowance.

- **The personal side**

The owner gets a Schedule A itemized deduction for the real estate taxes allocable to his personal use of the vacation home. However, since personal use does not exceed the greater of 14 days or 10% of the time the unit is rented out, the home is not considered a qualified residence. As a result, the interest paid on a mortgage secured by the vacation home, and allocable to personal use, will be treated as nondeductible personal interest.

- **Tax-free sale of vacation home**

A taxpayer may sell his regular home at retirement and move into what had been his vacation home. If the vacation home is later sold, gain on the sale of both homes is eligible for the up-to-$250,000 exclusion ($500,000 for qualifying married taxpayers) if each is owned and used as a principal residence for at least two of the five years preceding the sale date of each home, and two years elapse between the sales. However, the part of the gain attributable to depreciation for post-May 6, 1997, periods isn't eligible for the exclusion. Short temporary absences for vacations or other seasonal absences, even if the taxpayer rents out the property during the absences, are counted as periods of use for purposes of the two-out-of-five year ownership and use requirement.