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Vacation Home Tax Considerations

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What are vacation home tax considerations?

First of all, the IRS differentiates between vacation homes and second homes. The tax treatment of your additional residence will depend largely on how much time you (or a family member) use the property for personal purposes relative to the amount of time you rent it to others. Whether you own a vacation home or second home, you should understand what types of home-related expenses you can deduct on your federal income tax return and the extent to which they may be deducted. You should also know how to treat rental income.

Definition: "personal use" of home

For tax purposes, you must count as "personal use" any day your home is used by:

- You or any other person having an ownership interest in the property
- A member of your family or a family member of any other person having an ownership interest in the property (unless the family member uses the home as his/her primary residence and pays a fair rental value for the use of the home)
- Anyone who, in return for use of your vacation home, allows you to use another home or dwelling unit
- Anyone who pays less than fair market rent for the use of the home

Example(s): This year, you used your vacation home for four days and allowed your daughter and her family to use it for three days. In addition, your sister (who has a 50 percent ownership interest in the vacation home) used it for seven days. She allowed her son to live in the home for six months. During that time, it was his primary residence and he paid fair market rent for it.

Example(s): Here, the total personal use for the year is 14 days (your 4 days of use, your daughter's 3 days of use, and your sister's 7 days of use). Because your nephew paid fair market rent and used the home as his primary residence while living there, his use of the home is not counted as "personal use" for your tax purposes.

Tip: If you use the bulk of a day spent at your vacation home to repair or maintain the home, you need not count this as a personal use day. This is true even if members of your family use the home for recreational purposes on the same day or days.

Definition: "family member"

Regarding personal use of your home, a member of your family is defined as a brother or sister, half-brother or half-sister, spouse, ancestor (i.e., parent or grandparent), or your "lineal descendant" (i.e., child or grandchild).

Vacation home tax treatment

A vacation home may be defined as a second residence with a combination of personal and rental use, where the home is rented 15 days or more per year and your personal use exceeds the greater of 14 days per year or 10 percent of the days rented.

- Deductions--You'll be allowed to deduct any casualty losses and property taxes you paid, as well as qualified residence interest (but only on one vacation home). Mortgage interest will only qualify as "qualified residence interest" if it is incurred with respect to your principal residence and one other residence. Thus, you will not be able to deduct the mortgage interest on more than one secondary residence or vacation home. There are also limits on the amount of indebtedness that may be taken into account in determining the amount of qualified residence interest that is deductible each year. For more information, see Home Mortgage Interest Deduction.

- Rental income--All rental income is reportable.
- Expenses--Expenses must be allocated or prorated between personal use and rental use of the property. Essentially, deductions (other than qualified residence interest, property taxes, and casualty losses) are limited to the amount of income generated by the property. These expenses include insurance, repairs, utilities, and depreciation (in that order); you are required to subtract these expenses from the rental income in a specified order.

Allocation of expenses: specifics

Limited expenses must be allocated in the following order:

1. First, expenses that are allowable regardless of the rental activity, such as qualified mortgage interest, property taxes, and casualty losses
2. Second, rental expenses that do not affect the basis of the property, such as utilities, management fees, maintenance fees, Realtor ® commissions, and advertising fees
3. Third, expenses that will affect the basis of the property, such as depreciation

When applying these rules, the expenses in the second and third categories cannot produce a taxable loss. Rather, these deductions can be claimed only to the extent of rental income. However, any expenses limited under this rule may be carried forward and taken into account as a vacation home deduction for the following year.

Proration of expenses

Vacation homes are subject to a proration of expenses. The prorated amounts attributable to the rental activity are based on the number of days during the year that the home was rented. The rental portion equals the number of days the home is rented, divided by the total number of days during the tax year that the home was used for both rental and personal purposes.

> **Example(s):** Assume you used your vacation home for one month and rented it for the remaining 11 months of the year. Your expenses on the home during the year (including mortgage interest and property taxes) came to $9,200, and the total rent you received was $8,000.
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> **Example(s):** In this case, you must show the $8,000 as gross income on your tax return, but you can offset this "gain" by 11/12 of the expenses you incurred on the property, up to the full $8,000 in rental income. However, any shortfall between your expenses and the rent you received on the home is not deductible.
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> **Tip:** A controversy exists between the IRS and the U.S. Tax Court regarding proration of expenses when a vacation home is vacant for part of the year. The IRS position is that all expenses are prorated based on the period of actual usage or occupancy, rather than based on the entire year. Be sure to check the status of the law in your jurisdiction with your tax advisor.
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> **Example(s):** Jill bought a vacation home in Colorado and uses it each year during the month of April. She rents it out for three months during the year; the property is vacant the rest of the time. Jill incurs the following expenses this year: qualified residence interest of $2,000, real estate taxes of $400, maintenance and utilities of $1,500, and depreciation of $2,500. If the gross rental income is $3,000, the proration under the IRS method is as follows:
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> **Example(s):** Rental income. $3,000Deductions:1. Taxes and interest ($2,400 x ¾). ($1,800)2. Maintenance and utilities ($1,500 x ¾). ($1,125)3. Depreciation ($2,500 x ¾, but limited to remaining income). ($75)
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> **Example(s):** Jill will report no income on her Schedule E for this rental property. The remaining $600 of qualified residence interest and tax ($2,400 - $1,800) is for personal use and may be deducted as an itemized deduction on Schedule A.

For additional information about vacation homes, see Sale of Vacation Home: Tax Considerations. For information about passive activities and at-risk rules, see Converting a Residence to Rental Property.

Second home tax treatment

A second home is a personal residence that you rent to others for fewer than 15 days per year. The tax treatment is as follows:

- Deductions: You'll be allowed to deduct any qualified residence interest and property taxes you paid on the home during the year (subject to the normal limitations on mortgage interest deductions for primary and second homes). You can also deduct casualty losses.
- Rental income: Rental income you receive is not subject to taxation.
- Expenses: Expenses related to the rental of the property are not deductible.

See also Home Mortgage Interest Deduction.

IMPORTANT DISCLOSURES

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To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

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