

# TAX COMPLIANCE & PLANNING TRENDS

## Making the Best Tax Use of a Vacation Home Under the Latest Rules

A soft real estate market in many areas has led to buying opportunities in vacation or second homes. This market offers a chance to provide families with a place to rest and relax at a possibly reduced cost, and at the same time, have a shot at capital appreciation over the long term. It also offers a chance to earn some rental income when the owner or family members aren't using the property.

### TAX RULES for VACATION HOME RENTALS

#### Tax-free 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. (Code Sec. 280A(g)) 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 (e.g., one near a prime sporting event) where even a few rental days can bring in substantial dollars.

#### 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 percent of the days the property is rented to others during the year at a fair rental. (Code Sec. 280A(d)(1)) 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, under Code Sec. 280A(c)(5), deductions can't exceed rental income less:*

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

*Example:* 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 a rental period begins. These types of expenses should be deductible (e.g., at the rate of \$.485 per mile in 2007 for driving) along with other rental-related costs.

2. 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).

In regard to excess expenses, they 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 by Code Sec. 280A(c)(5), he doesn't have to worry about the passive loss rules for that year; they specifically don't apply in this situation. (Code Sec. 469(j)(10))

#### 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 percent of the days it is rented out during the year, the vacation home is a qualified residence for purposes of the mortgage interest deduction. (Code Sec. 163(h)(4)(A)(i)(II)) 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

### *IRS vs. Tax Court Definitions*

IRS says that all expenses are apportioned between rental and personal use based on the number of days used for each purpose. (Prop Reg § 1.280A-3(d)(3)(iii); IRS Publication 527, 2006, pg. 8) However, the Tax Court, the Ninth and the Tenth Circuits maintain that 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.

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.

### *Tax Credit for Energy Saving Property Installed in Vacation Home Used as a Residence*

For property placed in service in 2007, taxpayers may claim a Code Sec. 25D credit for the following types of property installed in their residences:

- Qualified photovoltaic property (i.e., property that uses solar power to generate electricity in a home)—the credit is 30 percent of the cost, up to a maximum credit of \$2,000; and
- Qualified solar water heating property—30 percent of the cost, up to a maximum credit of \$2,000. (Code Sec. 25D(d)(1))

The term *residence* takes in not only the taxpayer's main home but a vacation home treated as a residence due to limited rentals. By contrast, otherwise eligible equipment installed during 2007 on a vacation home used as rental property under the rules explained below would not generate a tax credit. Also, note that there are other types of property that can generate an energy saving credit under Code Sec. 25C and Code Sec. 25D, but only if installed in a principal residence.

## 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 greater of 14 days or 10 percent 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 Sec. 469(c)(7) 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 adjusted gross income (AGI) doesn't exceed \$100,000, then 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. (Code Sec. 469(i)(3)(A))

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 that 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. (S Rept No. 99-313 (PL 99-514), 1986-3 CB 737) The \$25,000 allowance won't be available if a management or rental agent handles all aspects of renting the unit and maintaining it. See, e.g., Madler, (1998) TC Memo 1998-112.

The rules are different if the property is not treated as a rental activity under the special rules of Reg. § 1.469-1T(e)(3)(ii). For example, if the average period of customer use is seven days or less, the property will be treated as a trade or business, which means the taxpayer must be a material participant in the activity in order to claim deductions in excess of income.

### **Personal Portion**

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 percent of the time the unit is rented out, the home is not considered a qualified residence under Code Sec. 163(h)(4)(A)(i)(II). 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. (Code Sec. 121(a), Code Sec. 121(b)(3)) However, that part of the gain attributable to depreciation for post-May 6, '97 periods isn't eligible for the exclusion. (Code Sec. 121(d)(6)) 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. (IRS Publication 523, 2006, pg. 13, Reg. § 1.121-1(c)(2)(i))

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