CPA GROUP OFFERS ADVICE

How Vacation Home Ownership Affects Your Taxes

If low interest rates, stable home prices, and glimmers of an economic recovery have you thinking about buying a vacation home this fall, the N.C. Association of Certified Public Accountants has some advice for you.

The affordability of your beach cottage or condominium may be affected by how frequently you use it and how often you rent it.

Restricting Your Home To Personal Use

Before purchasing a vacation home, the most fundamental question to consider is whether the house will be used primarily for rental purposes or personal pleasure. If you never rent your new home, the tax rules are quite clear. You may deduct mortgage interest and property taxes, just as you do on your primary residence. In addition, you may rent your home for up to 14 days a year and collect tax-free rental income.

Be aware that for non-rental properties, homeowners may deduct mortgage interest on their primary residence and one other home. So if you are thinking about buying a third home for personal use, be sure to consider the lost mortgage interest deduction in estimating the cost of the purchase.

Mixing Business And Pleasure

If you're like most people, you may want to use your vacation home part of the time and rent it out at other times to generate income. Using your second home for both pleasure and business subjects it to different tax treatment. Generally, the more frequently you use your vacation home, the fewer the tax benefits.

For a second home to be treated as rental property, you may not use it for personal purposes for more than 14 days during the year or for more than 10 percent of the total number of days it is rented during the year at fair market value, whichever is greater.

If your home is considered rental property, your deductions are restricted by the passive loss rules, not by the vacation home rules. The income and deductions the home generates are considered passive in nature. If deductions allocable to the rental portion exceed rental income, the loss can only be used to offset other passive income. In addition, since the home is not considered qualified residence under the interest deduction rules, the mortgage interest allocable to your personal use of the home is considered personal interest and is non-deductible.

The biggest tax break you get from rental property is the ability to deduct a portion of your purchase price each year. This gradual write-off—called depreciation—compensates you for the general wear and tear of your property.

If your personal use exceeds the greater of 14 days or 10 percent of the number of days during the year for which the home is rented at fair market value, you include the rent as income and claim offsetting deductions for the rent-related portion of expenses, such as utilities, upkeep, interest, real estate tax, insurance and depreciation.

The deduction cannot exceed rental income less (1) deductions related to the rental activity itself, such as advertising; and (2) interest and real estate taxes allocated to rental use. Any excess expenses may be carried forward to future years. Since the home is considered a qualified residence for purposes of the interest deduction, you can deduct the personal use portion of your mortgage interest as an itemized deduction.

Personal Use

The Internal Revenue Service definition of personal use is more inclusive than you may think. If you let anyone—relatives, friends, or business associates—use your vacation home without charging them fair rental value, the time they spend there will be viewed as personal use, thereby limiting your deductions.

The IRS strictly enforces these rules. For example, suppose you donate a week at your vacation home as a charitable cause and the charity auctions the week off at fair market value. Because you do not personally receive the rental income, you are treated as personally using the home for that week.

The IRS does recognize that you will need to spend some time maintaining and repairing your vacation home. For this reason, days spent doing repairs, painting or even cleaning the home for the next renter are not treated as your personal days.

Qualified Deductions

The biggest tax break you get from rental property is the ability to deduct a portion of your purchase price each year. This gradual write-off—called depreciation—compensates you for the general wear and tear of your property.

You may also take a tax deduction for repair costs, utility bills, insurance, cleaning services, and even fees incurred to advertise and rent your property.

Be aware, however, that some restrictions apply. The losses you pile up when renting property are considered passive losses and are therefore subject to passive loss rules. Generally, if you are actively involved in managing your rental property, you may deduct up to $25,000 in passive losses against nonpassive income (such as wage income).

Your ability to deduct passive losses is also affected by a gross income limitation. The $25,000 allowance is reduced by 50 percent of the amount by which your adjusted gross income (AGI) exceeds $100,000 and completely disappears once your AGI hits $150,000.

Finally, don't let the complexity of the tax law dissuade you from purchasing a vacation home. CPAs say your personal financial situation will help determine whether it makes smart tax sense to use a vacation home for personal and business purposes.