



Vacation Homes: Tax Consequences of Operating & Selling

If you have a vacation home that you use personally as well as rent it out for a period of time, the tax consequences of the net rental income depends on how many days the home is used personally and how many days of rental there are in a year.



Rented less than 15 days with personal use more than 14 days – FREE

For a vacation home in this category, the tax rules are really simple. This is one of the few times in the tax code where income is truly tax free. You are not required to report any of the rental income on your personal tax return. You also cannot deduct expenses directly attributable to the rental period (rental agency fees, cleaning, and so forth).

Rented more than 14 days with “substantial” personal use – property defined as personal with rental income

“Substantial personal use” is if your personal use exceeds the greater of: (1) 14 days or (2) 10% of the rental days. For example, a vacation home that’s rented for 16 days during the year and used by you and family member for 20 days falls into this slot.

Personal usage includes use by you, other family members (whether they pay fair market rent or not) or anyone else who pays less than market rent. Personal use also includes time spent at your place by another party under a reciprocal sharing arrangement (“I use your place in exchange for you using my place”) whether the other party pays market rent or not.

Days devoted principally to repairs and maintenance are considered days of vacancy and are disregarded, even if family members are present while you work away.

Vacation homes in this category are treated as personal residences for federal income tax purposes but the rental

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activity must be reported on Schedule E of your tax return as follows:

- Report 100% of rental income (including income from usage designated as “personal” – see above) on Schedule E of Form 1040.
- Deduct 100% of any direct rental expenses (e.g. rental agency fees and advertising) on Schedule E.

Allocate mortgage interest and property taxes between rental and personal use. Deduct the allocated rental mortgage interest and property taxes on Schedule E. (The personal use portion is deducted on Schedule A if you are itemizing deductions).

If there's any net rental income left after deducting direct rental expenses and allocated mortgage interest and property taxes you may deduct as rental costs allocable indirect expenses — maintenance, utilities, association fees, insurance, depreciation and so forth on Schedule E — but only to the point where you zero out rental income. In allocating these indirect expenses, consider only actual rental and personal-use days during the year, and ignore days of vacancy. For example, if you rent your vacation home for 90 days during the year and use the property 60 days for personal purposes, allocate 60% of the maintenance, utilities, and so forth to rental usage and 40% to personal usage. The 40% is non-deductible. Even so, the bottom line on Schedule E will often be zero, because the rental income will often be fully offset by deductible expenses.

You are allowed to carry over any disallowed allocable indirect expenses to future years when you can deduct them against rental profits (if you ever have any) or, ultimately, when you sell the property at a gain.

Rented more than 14 days with “de minimis” personal use – property defined as rental with personal use

“De minimis personal use” is if your personal use is less than the greater of:(1) 14 days or (2) 10% of the rental days. See above for definition of personal use. If your vacation home usage falls into this category, it will be classified as a rental property with personal use.

For vacation homes that are classified as rental properties, mortgage interest, property taxes, and other expenses must all be allocated between rental and personal use based on actual days of rental and personal occupancy.

Personal use portion of mortgage interest deduction

Mortgage interest allocable to personal use of a rental property does not meet the definition of qualified residence interest for itemized deduction purposes. The qualified residence interest deduction is only allowed for mortgages on properties that are classified as personal residences.

Rental losses and the passive activity loss (PAL) rules

When allocable rental expenses exceed rental income, a vacation home classified as a rental

property can potentially generate a deductible tax loss that you can report on Schedule E of your Form 1040.

Unfortunately, your vacation home rental loss may be wholly or partially deferred under the dreaded passive activity loss (PAL) rules. Here's why. You can generally deduct passive losses only to the extent that you have passive income from other sources (such as rental properties that produce positive taxable income). Disallowed passive losses from a property are carried forward to future tax years and can be deducted when you have sufficient passive income or when you sell the loss-producing property.

A favorable exception to the PAL rules allows you to currently deduct up to \$25,000 of annual passive rental real estate losses if you "actively participate" and have adjusted gross income (AGI) under \$100,000. The \$25,000 exception is phased out between AGI of \$100,000 and \$150,000. The IRS says the \$25,000 exception is not allowed when the average rental period for your property is seven days or less.

What happens when you sell the property?

Rental less than 14 days

If your rental use has always been less than 14 days per year the tax consequences when you sell the property are the same as they would have been had you never rented the property at all. In other words, if this is not your principal residence for two of the last five years, the net gain on the sale is taxable in full. If it was your principal residence, the gain is excluded (in whole or in part) using the rules regarding sale of principal residence.

Personal property with rental use

If the property has been defined as personal with taxable rental use, the loss on the sale is not deductible but any gain is taxable (less suspended losses from previous years). The gain is classified as capital gain except for the portion that is recapture of depreciation expense taken during the rental period.

Rental Property with personal use

If the property has been classified as a rental property with occasional personal use, the loss on the sale allocated to the rental portion is deductible in addition to any suspended losses from previous years. If there is a gain on the sale, the whole gain is taxable as it would not be eligible for exclusion under the personal residence rules. The gain would be classified as capital gain except for the portion that is recapture of depreciation expense taken during the rental period.

