Owning a second home

What's the tax impact?

By Melinda Nelson, CPA

What does owning a second home mean for your taxes? This is a common issue for millions of homeowners. You may not be sure if your second home is a vacation home, rental property or personal residence for tax purposes. Are you wondering what deductions are available and what income is taxable? The answer is based on how much you personally use the home and how often you rent it out. There are three factors outlined by the IRS that can help determine what type of property you own.

Properties rented 14 days or less a year

If you bought a second residence for the sole purpose of your personal enjoyment and personally use the property as a residence – maybe you like to get away to the beach – and you rent it out for less than 15 days a year, it is considered a vacation home for tax purposes. You can generally deduct the mortgage interest and real estate taxes of your vacation home, just as you would on your primary residence. You will itemize them by filling out a Schedule A. Hopefully your itemized deductions end up greater than the standard deduction to lower your taxable income even more.

As a bonus, the tax law even allows you to rent out your vacation home for up to 14 days a year without paying taxes on the rental income received (this same rule applies to your primary residence). Of course, you will not be able to deduct any of the rental-related expenses such as utilities, having the house cleaned, etc.

While you don't have to pay tax on rental income if you rented less than 15 days, some companies such as Airbnb, HomeAway and VRBO may report all the rent you received to the IRS. If you receive a Form 1099-K, Payment Card and Third Party Network Transactions, or Form 1099-MISC, Miscellaneous Income, the IRS may contact you for additional information regarding your property and the rent you received.

It's important that you keep good records to document the use of your property by day. This will give you the information you need to show you rented the property 14 days or less and reported the rent correctly.

Properties rented for 15 days or more AND the owner uses it less than 14 days

Whether you bought your second home to rent out for a couple of weeks, a month or a year, it's treated all the same for tax purposes – as a rental property. If you use your property for less than 14 days or 10% of the time it's rented, your second home has been turned into an investment.

Your rental income and expenses are reported on Schedule E as a rental activity – unless you perform lots of personal services, then Schedule C may be the appropriate form. Some of the typical expenses you would report include insurance, maintenance, mortgage interest, property taxes, utilities and depreciation. You may be able to deduct up to $25,000 each year in losses, depending on your adjusted gross income (AGI) and your participation in the management of the property.

Owner uses the property for the greater of: more than 14 days or 10% of the total days the home was rented

If the number of days you spend at your second home exceeds 14 days or 10% of the number of days the home is rented out (whichever is greater), the IRS considers your property a personal residence. This means you cannot deduct any rental losses. However, you can deduct rental expenses up to the level of rental income, as well as property taxes and mortgage interest. The amount of rental expenses you can deduct is based on the percentage of days your vacation home was rented out for the year versus personal use.

Again, keeping good records regarding the use of your property will be the key to preparing your tax return correctly.

Time to sell the property

So you've decided it's time to sell your property. What are the tax consequences of selling? Any time you have a gain on sale it will be potentially taxable if you sell a home that is not your primary residence. If you sell a personal residence at a loss, no tax deduction is allowed. If your second home is now an investment property, deferring the income tax may be an option by reinvesting in another property under IRC 1031.

In all cases, the tax code is complicated and there's always more information that needs to be considered. Be sure to talk to your tax professional advisor so he or she can easily guide you through this process and answer any questions.

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