Tax Angles to Vacation Home Rentals

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Do you own a vacation home in a resort area? If you do, it can be more than just a place to get away from the daily grind. The home may also be a source of valuable income tax deductions. Typically, you can deduct property taxes and mortgage interest (assuming the combined acquisition debt on your main home and your vacation home does not exceed $1 million).

Suppose you rent your vacation home when your family is not using it. The rental income you receive can offset some of the costs of ownership. Of course, the income is taxable, but you may claim offsetting deductions for a portion of your expenses. For instance, if you rent the home for 75% of the time and use it personally for 25% of the time, you can deduct 75% of your insurance, repair costs, depreciation on the home and so forth.

But let's say you are running a loss on the rental—your rental-related expenses (including mortgage interest and property taxes allocable to the rental) exceed the income you receive. Now things get a little more complicated. Under the passive activity loss rules, you can only use losses from a rental activity to offset losses from other passive activities. However, if you are an active participant in the rental (e.g., you make management decisions), the tax consequences depend on your income level and the level of your family's personal use.

There are three basic rules to follow:

1. If your income does not exceed $100,000, you can use the loss to shelter up to $25,000 of your salary and other income as long as you keep your personal use to a minimum. Your family's personal use cannot exceed the greater of 14 days or 10% of the rental time. When you keep your personal use below these limits, you lose a portion of your mortgage interest deduction (the portion allocable to your personal use).

2. If your income is $150,000 or more, the tax law says you cannot qualify for the $25,000 loss write-off. Your total rental deductions basically cannot exceed your rental income, regardless of the amount of your personal use. However, if your personal use is greater than 14 days or 10%, you get an additional deduction which is the portion of your mortgage interest you do not claim as a rental expense.

3. If your income is between $100,000 and $150,000, things are not so clear-cut. The $25,000 loss write-off is gradually phased out in this income range. The closer you are to the $150,000 level, the more likely it is you will get little in the way of a loss write-off.

So you will probably want to increase your personal use—the same strategy for those with incomes above $150,000. This way, you will be able to deduct more of your mortgage interest.

Conversely, if you are closer to the $100,000 level, most of your loss write-off will be intact. Therefore, try to keep your personal use below the 14-day/10% mark.

Note that there is a unique tax opportunity if you rent the home for two weeks or less during the year. You do not have to report any income or expenses on your personal tax return. All the rental income is effectively tax-free.

The tax rules in this area can be tricky. Do not hesitate to contact your Henry & Horne, LLP tax professional for assistance.

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