

Vacation Home Rules – Planning Tips and Opportunities

As we are in vacation season, I thought it would be a good time to provide an update on the tax rules (and how to work them to your advantage) related to vacation (second) homes. As usual, my purpose here is to offer some planning tips that might not be obvious rather than a complete discussion of the topic, but following are the basic ground rules.

If you use the second home for personal use only, it is treated like an adjunct to your principal residence; you can deduct interest (but see note below) and taxes, but not other operating costs (utilities and so on). If you have minimal days of personal use (14 days or less or 10% of days actually rented if that is more than 14 days) and the home is rented, the home is treated as a rental property and revenue is picked up but offset by operating expenses (like a regular rental property, but note comment below). If you exceed the minimal personal use amounts and rent the house as well, you have to allocate costs; generally part treated as vacation home, part treated as rental property, but rental deductions are only available to reduce rental income, not to create a tax loss.

- It is worth noting that a second home is not just a ski lodge or mountain cabin, but anything can qualify that has sleeping, cooking & bathroom facilities. So a motor home or large boat can qualify, even a pop up camper has been ruled to qualify.
- As noted, the statute categorizes a vacation home that has minimal personal use but is rented as a rental property. This allows you to create a tax loss if expenses (including depreciation) exceed income. This is fine if you are a real estate professional, but if not the rental loss would be subject to the passive loss rules. A big workaround on this is if the rentals are short-term (less than 30 days), the property is categorized more like a hotel and the loss is no longer passive in nature. You do have to demonstrate you are active in the management of the property.
- In counting the number of personal use days (to see if you test out for the point above), days that you are at the property for maintenance activities do not count as personal days. So even if you stay at the property, you can exclude those days.
- Any income realized that represents 14 days or less of rental for the year is completely tax free, so consider that as an option if your home is in an area with an extreme peak season with a spike in rates --- mountain resort at high season, for instance.
- The ability to deduct interest on a loan for the second residence should be considered as well. The general rule is you can deduct interest on up to \$1 million in acquisition indebtedness on the primary and second residence plus interest on up to \$100,000 of home equity lines. If you don't place mortgage debt on the second home when you originally buy it, you may be limited on the ability to deduct interest if done later (limited to the \$100,000 (at best)).
- If you are planning to sell a second residence, some advance planning can be useful. For instance, if selling for a gain, use of a like-kind exchange is possible. To get that treatment you generally have to show that the home has been held primarily for investment, rental or maybe as a farm or ranch property (not just a vacation property), which could also benefit you if you sell for a loss.
- If the second residence is a legacy asset that will be used by future generations, it may be desirable to put it into a family partnership so interests can be transferred (at a discounted value) to future generations. Alternatively, use a Qualified Personal Residence Trust or an installment sale with a self-cancelling feature. This can be embellished by the use of a conservation or scenic easement on the property (if suitable) to free up a charitable deduction and/or state credits while retaining the asset.

The information here is in an abbreviated form. If you have a particular question, or would like more complete coverage of an item, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.