CLEARPOINT

JULY 2023

JONATHAN A. WATTS, CPA, MANAGING DIRECTOR

VACATION HOME TAX CONSIDERATIONS

BY JONATHAN A. WATTS, CPA, MANAGING DIRECTOR

Ah, summertime. Campfires by the lake, mountain escapes, and tropical drinks by the ocean. Vacation homes offer opportunities for lasting memories for individuals and families.

Vacation homeowners often dream of keeping the property in the family for generations. Others purchase the home with visions of spending their golden years there in retirement. Many see real estate appreciation as the primary goal, with the hopes of realizing a cash windfall in the future. More entrepreneurial owners see the opportunity to rent out the property when not in use by family.

Each scenario involves its own set of planning considerations, and the related tax rules can prove more complicated than some might expect.

CATEGORIZING PROPERTIES FOR TAX PURPOSES

Many vacation homeowners may decide to rent out their home to help defray the cost of ownership. Depending on how the home is used, it will fall into one of the following three categories[1] for tax purposes.

A. *Personal Residence.* A residence that is rented out for fewer than 15 days during the year.[2]

IN OTHER NEWS...

WEATHERING WHAT'S TO COME

OPERATIONAL, FINANCIAL, & INVESTMENT REALIGNMENT FOR CHALLENGES FACING HIGHER EDUCATION

With the rising costs of tuition, decreased enrollment, and increasing financial pressures, higher education institutions are under immense scrutiny to evolve and adapt to survive.

Clearstead sponsored and led a panel of university administrators and experts in the field of finance at the 2023 OACUBO Conference to discuss these challenges as well as potential strategies to address them.

An article summarizing the panel discussion can be found on our website.

B. *Vacation Home.* Property with a combination of personal and rental use if (1) **personal** use exceeds the greater of 14 days or 10% of rental days and (2) **rental** use exceeds 14 days.[3]

C. *Rental Property with Personal Use.* Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.[4]

The tax treatment for each of these categories can differ significantly. The chart in **Figure 1** can assist in determining a property's category. After establishing how the home will be classified for tax purposes, homeowners should take time to understand the intricacies of the rules. Note that a property's designation for tax purposes can change from one year to the next, depending on how the property is used during the applicable year.

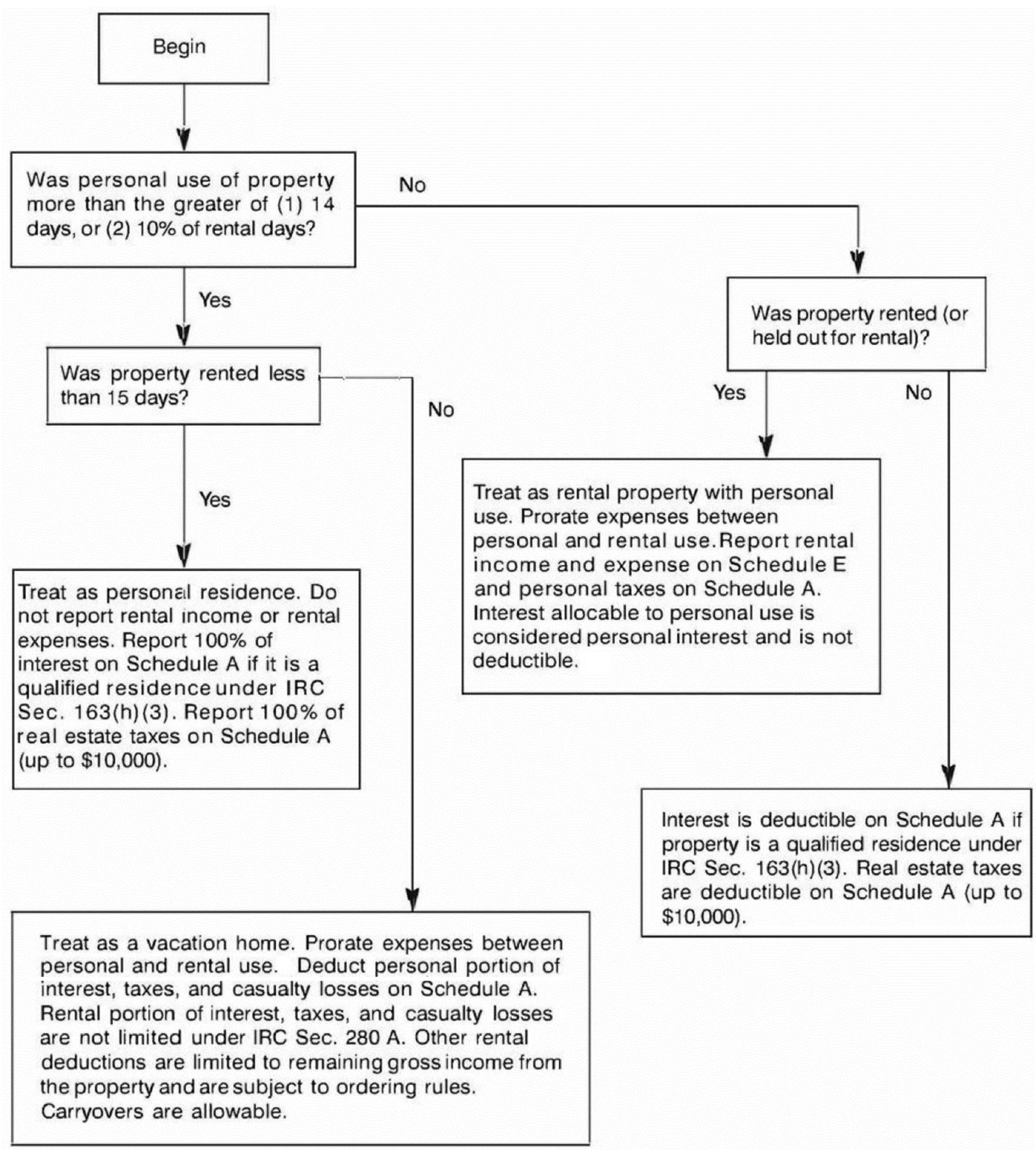

Figure 1 - Flowchart to Determine Tax Treatment of Home with Rental and Personal Use

VACATION HOME TAX CONSIDERATIONS

BY JONATHAN A. WATTS, CPA, MANAGING DIRECTOR

PERSONAL RESIDENCE

If a property is used personally for more than 14 days during the year, or more than 10% of the number of days it is rented (if greater), then the property is considered a **residence** for tax purposes.[5] If this residence is rented for fewer than 15 days during the calendar year, it is solely considered a personal residence. The homeowner is not entitled to deduct expenses associated with the rental of the property, and income received from the rental use is not taxable.[6] However, certain interest expenses and real estate taxes may be deductible (within current limits) as itemized deductions on an individual tax return.

Under this special rule for properties classified as personal residences, since rental income is ignored, the taxpayer effectively receives nontaxable, nonreportable income. This rule applies whether the property is the taxpayer's primary residence or a second home. It can be of significant benefit to taxpayers who rent their home for short-term events such as Mardi Gras, political conventions, sporting events, etc. The rule also applies to taxpayers who use a vacation home primarily for personal purposes but rent it for fewer than 15 days during the year.

VACATION HOME

If a **residence** (defined previously as property used personally for more than 14 days and fewer than 10% of rental days) is rented for more than 14 days, the reporting of income and deductions is subject to certain rules and limitations.[7] This is a typical situation for many vacation homeowners. In these cases, **deductions** (other than qualified residence interest, taxes, and casualty losses) **are limited to the amount of the income from the property**. Expenses that cannot be used in the current year because of the net income limitation are carried forward to future years.[8]

In determining allowable deductions for properties classified as vacations homes, a set of ordering rules applies:[9]

Tier 1 Expenses. Qualified residence interest, taxes not in excess of the $10,000 itemized deduction cap, casualty losses, and rental expenses not directly attributable to operating or maintaining the property (e.g., commissions and advertising).

Tier 2 Expenses. Operating expenses (including nonqualified residence interest and taxes in excess of the $10,000 cap), except depreciation.

Tier 3 Expenses. Depreciation and other basis adjustments.

When applying these rules, the expenses in Tier 2 and Tier 3 cannot produce a tax loss. **The deductions in the last two tiers can be claimed only to the extent of rental income, and they are deducted in the specified order**. Consequently, if the deductible interest and taxes completely offset the rental income, the operating expenses and depreciation are not deductible. Any expenses limited under this net income rule are eligible for carryforward to future years, but they remain subject to the net income limitation.[10] These rules will be illustrated in a later example.

RENTAL PROPERTY WITH PERSONAL USE

If a property is rented during the year, and personal use does not exceed the greater of 14 days or 10% of rental days, then the property is not considered a “residence” for tax purposes. Rather, it is characterized as a **rental property**. As such, the ordering tiers described above for vacation homes do not exist, and rental expenses are not limited to gross rental income.[11] However, even if personal use does not exceed the limits stated above, **expenses must still be allocated between the personal use and the rental expense, based on days of usage**, as discussed below.[12]

PRORATING EXPENSES BETWEEN RENTAL AND PERSONAL USE

Properties treated as either vacation homes or rental properties with personal use require a proration of expenses between rental and personal use. The expenses attributable to rental are determined based on the ratio of days the property is rented at a fair rental to the total days it is used during the year.[13] The balance of the expenses is considered personal.

This rule is important and can give rise to unpleasant surprises. In some situations, even a single day of personal use can result in losing a significant amount of tax deductions. For example, if a property is vacant but held out for rent for an entire year, all expenses are deductible since the property is held to produce income and treated as a rental property. The vacation home rules do not apply since there is no personal use of the property. However, if the owner were to spend a single personal day at that property, all expenses (except for property taxes) would become nondeductible personal expenses. As discussed above, expenses are allocated based on the days used for rental activity relative to total days the property is used. In this example, since the property is used a single day during the year for personal use, the fraction of the expenses attributable to the rental activity would be zero (zero rental days divided by one day of use). In addition, interest that is not allocated to the rental activity would not qualify as home mortgage interest since the property was used only one day – i.e., it is not considered a "residence."

WHAT IS PERSONAL USE?

The tax rules define personal use to include not only use by the homeowner, but also members of the homeowner's family, or another person having an interest in the property. Personal use also includes any use by a person paying less than a fair rental.[14] Thus, if the owners allow their child's college roommate to use the home without charge for two months, even though it is rented to outsiders under an arm's length lease for the other ten months of the taxable year, the property will be subject to vacation home treatment, and loss will be limited to income. For a property owned by a partnership or LLC, use by a partner or a member of a partner's family also counts as personal use.[15]

The following example helps illustrate the rules described above.

Example: Assume you own a vacation home, and you rent it out for 60 days and use it personally for 20 days. You are paid rent of $8,000. Expenses are $6,000 in interest and taxes, $3,600 operating costs, and $4,800 depreciation, for a total of $14,400. Personal use is 25% (20 out of 80 total use days). 75% of expenses are allocated to rental ($14,400 × 75% = $10,800). There is thus a rental loss of $2,800 ($8,000 income, $10,800 expenses). However, personal use (20 days) exceeds the greater of (1) 14 days and (2) 10% of rental days (6). The loss is therefore disallowed. You can deduct only $8,000 of expenses (up to the rental income). You must first deduct the rental portion (75%) of the Tier 1 expenses - interest and taxes ($4,500 [75% of $6,000]), then 75% of the Tier 2 operating costs ($2,700 (75% of $3,600), which totals $7,200 ($4,500 plus $2,700). You can then deduct only an additional $800 worth of Tier 3 expenses - depreciation.

CONSULT YOUR TAX ADVISOR!

Tax rules surrounding vacation homes are more complicated than most would-be landlords realize. If you are considering renting out your home, whether your primary personal residence, a vacation home, or a rental property you do not intend to use personally, fully considering the tax implications is crucial. With a complete understanding and careful navigation of the tax rules, vacation homes can be a great asset for you and your family for generations.

Sources:

(1) IRC Sec.280A
(2) IRC Secs. 280A(d)(1) and 280A(g)
(3) IRC Sec. 280A(d)(1)
(4) IRC Sec. 280A(c)(3)
(5) IRC Sec. 280A(d)
(6) IRC Sec. 280A(g)
(7) IRC Sec. 280A(c)(5)
(8) IRC Sec. 280A(c)(5)
(9) Prop. Reg. Sec. 1.280A-3(d)(3)
(10) IRC Sec. 280A(c)(5)
(11) IRC Sec. 280A(c)(3)
(12) IRC Sec. 280A(e)
(13) IRC Sec. 280A(e)(1)
(14) IRC Sec. 280A(d)(2)(C)
(15) IRC Sec. 280A(f)(2) ; Prop. Reg. Sec. 1.280A-1(e)(5)

VACATION HOME TAX CONSIDERATIONS

BY JONATHAN A. WATTS, CPA, MANAGING DIRECTOR

MARKET BENCHMARK RETURNS

June 30, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	6.6%	8.7%	19.6%	16.9%
US Small Cap	Russell 2000	8.1%	5.2%	12.3%	8.1%
Developed Intl	MSCI EAFE	4.6%	3.0%	18.8%	11.7%
Emerging Intl	MSCI Em Mkt	3.8%	0.9%	1.7%	4.9%
Real Estate	NAREIT	5.7%	1.6%	-4.3%	3.1%
Core Fixed	BarCap Agg	-0.4%	-0.8%	-0.9%	2.1%
Short Fixed	BarCap 1-3Yr	-0.4%	-0.4%	0.5%	1.1%
Long Fixed	BarCap LT G/C	0.8%	-1.3%	-2.6%	4.4%
Corp Debt	BarCap Corp	0.3%	-0.3%	1.4%	3.1%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.