

VACATION HOMES CAN BRING RELAXATION AND TAX RELIEF

Owning a vacation home gives you a great opportunity to relax and have fun in the sun—or snow—depending on your preferences. To add to your enjoyment, a vacation home also can provide significant tax benefits. Here's information that all current and would-be vacation homeowners should know.

DEDUCTIONS FOR VACATION OWNERS

Most people can fully deduct mortgage interest and property taxes on their vacation homes just as they can with a personal residence. Under current tax law, interest is deductible on the first \$1 million in mortgage debt used to buy, construct or improve a principal residence and second home. If you have more than one vacation home, for tax purposes, you'll want to designate as your second home the residence with the largest total deductions for mortgage interest. Property taxes are deductible no matter how many vacation homes you own.

If you rent your vacation home, you may be entitled to extra tax benefits. But be forewarned: The rules are complex and may require the professional advice of a CPA. There are different scenarios, each with unique tax implications.

MOSTLY YOURS: MINIMAL RENTAL BRINGS TAX BONUS

If you rent your home for no more than 14 days a year, you get a simple, but very generous, tax break. Any rental income you collect is tax-free. You don't even have to show the income on your tax return, and your eligibility to deduct interest and property taxes is unaffected. However, any rental-related expenses you incur from renting your home for 14 days or less are not deductible.

YOURS AND THEIRS: COMBINING PERSONAL AND RENTAL USE

If you rent your vacation home for more than 14 days a year and you and your family use the place more than 14 days a year (or 10 percent of the number of days it is rented, whichever is greater), a different set of rules applies. In this case, all of the rental income is subject to tax, but you're allowed to write off rental-related expenses—utilities, maintenance, and depreciation, for example—that do not exceed your rental income after taking the

allowable deductions for the property, such as real estate taxes and mortgage interest. You also can carry forward to future years expenses for the rental period that cannot be currently deducted.

MOSTLY THEIRS: LIMITED PERSONAL USE LEADS TO GREATER TAX BENEFITS

If you use your vacation property for personal use for less than 14 days (or 10 percent of the total rented days, if greater), your vacation home qualifies as rental property. If the average rental period is more than seven days, it may qualify as active rental real estate. That status makes it possible to write off more expenses—as much as \$25,000 in excess of rental income. This extra deduction, for what is called "passive losses," phases out when your adjusted gross income exceeds \$100,000 and is completely unavailable above \$150,000. If the average rental period is seven days or less, all losses from the rental property are passive losses and do not qualify for the active real estate deduction.

In general, you can deduct passive losses only from passive income, such as from rental properties that produce income or gains. There are additional rules about the order and limitations in which you can deduct expenses.

THE FINE PRINT: DEFINING PERSONAL USE

Not surprisingly, there are complicated rules for determining what constitutes personal use. According to tax law, days you spend repairing and maintaining your home on a full-time basis do not count as personal use, even if other family members use the home during the same time period for recreational purposes. On the other hand, if you allow family or friends to use your home for free or at a below market rental rate, be prepared to classify that time as personal use.

SELLING YOUR VACATION HOME

When it comes time to sell your vacation home, the capital gains exemption of up to \$500,000 does not apply. To qualify for the exemption, you would need to make the vacation home your principal residence for at least two of the five years before the sale. 

