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Vacation Home Rentals: How the Income Is Taxed

Article Highlights:

- Home never rented
- Home rented for fewer than 15 days
- Home rented for at least 15 days with minor personal use
- Home rented for at least 15 days with major personal use
- Vacation home sales

If you have a second home in a resort area, or if you have been considering acquiring a second home or vacation home, you may have questions about how rental income is taxed for a part-time vacation-home rental. The applicable rental rules include some interesting twists that you should know about before you begin renting. Although some individuals prefer to never rent out their homes, others find such rentals to be a helpful way of covering the cost of the home. For a home that is rented out part time, one of three rules must be considered, based on the length of the rental:

1. **Home Rented For Fewer Than 15 Days** – If a property is rented out for fewer than 15 days in a year, the property is treated as if it were not rented out at all: The rental income is tax-free, and the interest and taxes paid on the home are still deductible. In this situation, however, any directly related rental expenses (such as agent fees, utilities, and cleaning charges) are not deductible. This rule can allow for significant tax-free income, particularly when a home is rented as a filming location.

2. **Home Rented For At Least 15 Days With Minor Personal Use** – In this scenario, the home is rented for at least 15 days, and the owners' personal use of the home does not exceed the greater of 15 days or 10% of the rental time. The home's use is then allocated as both a rental home and a second home. For example, if a home is used 5% of the time for personal use, then 5% of the interest and taxes on that home are treated as home interest and taxes; these costs can be deducted as itemized deductions. The other 95% of the interest and taxes, as well as 95% of the insurance, utilities, and allowable depreciation, count as rental expenses (in addition to 100% of the direct rental expenses). The combined expenses for all rental activities are deductible as a tax loss. However, this amount is limited to $25,000 per year for a taxpayer with adjusted gross income of $100,000 or less and is ratably phased out between $100,000 and $150,000. Thus, if a taxpayer's income exceeds $150,000, the rental-expense tax loss cannot be deducted; it is carried forward until the home is sold or until gains from other passive activities can be used to offset the loss.

3. **Home Rented For At Least 15 Days With Major Personal Use** – In this scenario, a home is rented for at least 15 days, but the owner's personal use exceeds the greater of 14 days or 10% of the rental time. With such major personal use, no rental-related tax loss is allowed. For example, consider a home that has personal use 20% of the time and is a rental for the remaining 80%. The rental income is first reduced by 80% of the combined taxes and interest. If the owner still makes a profit after deducting the interest and taxes, then direct rental expenses and certain other expenses (such as the rental-prorated portion of the utilities, insurance, and repairs) are deducted, up to the amount of the remaining income. If there is still a profit, the owner can take a deduction for depreciation, but this is also limited to the remaining profit. As a result, no loss is allowed, and any remaining profit is taxable. The interest and taxes from the personal use (20% in this example) are deducted as itemized deductions, which are subject to the normal interest and tax limitations.

Vacation Home Sales – A vacation-home rental is considered a personal-use property. Gains from the sales of such properties are taxable, and losses are generally not deductible.

Unlike primary homes, second homes do not qualify for the home-gain exclusion. Any gain from a second home is taxable unless it served as the taxpayer's primary residence for two of the five years immediately preceding the sale and was not rented during that two-year period. In the latter scenario, the taxpayer does qualify for the home-gain exclusion, provided that he or she has not used that exclusion for another property in the prior two years. As a result, by the home-gain exclusion can offset an amount of gain that exceeds the depreciation previously claimed on the home; this amount is limited to $250,000 for an individual or $500,000 for a married couple filing jointly (if the spouse also qualifies).

There are complicated tax rules related to the home-gain exclusion for homes that are acquired in a tax-deferred exchange or converted from rentals to primary residences. Homeowners may require careful planning to utilize the home-gain exclusion in such cases.

As an additional note, when a property is rented for short-term stays or when significant personal services (such as maid services) are provided to guests, the taxpayer likely will be considered a business operator rather than just an individual who is renting a home. If so, the reporting requirements will differ from those outlined above.

As with all tax rules, there are certain exceptions to be aware of. Please call this office to discuss your situation in detail.