

Planning to Buy a Vacation Home?

You work hard, so what could be better than some much needed rest and relaxation? After all, just the thought of going to your very own bungalow on the beach drops your blood pressure. The tax implications of such a purchase may have the opposite effect, however. Before buying that home away from home, seek the advice of your certified public accountant! Here's why.

Vacation Home – A Definition. In the eyes of Uncle Sam, just what is a vacation home? How is it different from any other home? Tax law states that a vacation home is a dwelling used for both personal and rental purposes. If there is no rental use, it is simply a personal residence. In this application, a dwelling may be a house, but it could be a recreational vehicle such as a motor home or even a yacht. In general, it must have basic living accommodations to qualify. For tax purposes, there are four usage scenarios for this dwelling, or vacation home – each with its own set of rules. Under scenarios one and two, your property is taxable as a personal residence. Under scenarios three and four, it is taxable as a rental property. Which one is best for you?

Scenario 1. If you carefully plan the use of your vacation home, it could be considered a personal residence. This classification is desired in many instances because tax law allows you to deduct interest on up to \$1 million in mortgage debt on two personal residences. Property taxes are usually deductible no matter how many homes you own.

To be considered a personal residence, you or your family members must use your vacation home more than 14 days annually or 10% of the rental days, whichever is greater. You must also rent your place more than 14 days per year. This seems straight forward, but you must remember that any time the house is vacant, it is considered personal use time in the eyes of Uncle Sam. It really gets tricky when you account for rental income and expenses. Basically, you deduct expenses incurred while you use the home one way, and those incurred while you rent it, another. During rental periods, a

portion of operating expenses may be deductible. The good news is that your CPA can help you wade through this with a minimum of tax liability.

Scenario 2. The laws in this scenario are straight forward and benefit you, the taxpayer. Simply put, if you rent your home for 14 days or less and you or your family members vacation for more than 14 days, your vacation home will be considered a personal residence. You can deduct the interest, subject to the \$1 million mortgage limitation, and property taxes, but not operating expenses. Best of all, you do not have to report the rental income on your tax return. You can make a buck, and keep it all, with Uncle Sam's blessing.

Scenario 3. Okay, so you want to have a vacation home but, in reality, you or members of your family have little time to enjoy it. This means your home will fall under the tax rules for rental properties – that is, if you rent for more than 14 days a year and your personal use does not exceed 14 days or 10% of the rental days, whichever is greater. Here, the interest incurred during your personal use time is not deductible.

Rental properties are subject to passive activity rules. So, if the money you get from renting the house does not cover the cost of renting it, you may be able to show a taxable loss. There is a catch, however. You can generally deduct passive losses in a given tax year only against passive income from other rental properties that may produce income or gains.

Scenario 4. Suppose you go to the trouble of buying a vacation home, but life has other plans for your spare time. In this scenario, you spend no time at your vacation home during the tax year. Again, you have a rental property on your hands and it is subject to the same passive activity rules discussed in scenario three.

Final Thoughts. Has all of this made you rethink that bungalow? Don't let it. Just be cognizant of the fact that a visit with your CPA may be a good idea before you sign the papers.

For more information, contact one of our tax professionals today at 214.871.7500.