Tax Tips

Rental of Vacation Property

The tax treatment of a vacation property which is also used as a rental depends on how many days it's rented and your level of personal use. Personal use includes vacation use by your relatives (even if you charge them market rate rent) and use by nonrelatives if a market rate rent is not charged.

If you rent the property out for less than 15 days during the year, it's not treated as a "rental property" at all. In the right circumstances, this can produce significant tax benefits. Any rent you receive isn't included in your income for tax purposes (no matter how substantial the amount). On the other hand, you can only deduct property taxes and mortgage interest—no other operating costs and no depreciation. (Mortgage interest is deductible on your principal residence and one other home, subject to certain limits.)

If you rent the property out for more than 14 days, you must include the rent you receive in income. However you can deduct part of your operating expenses and depreciation, subject to the following rules. First, you must allocate your expenses between the personal use days and the rental days. For example, if the house is rented for 90 days and used personally for 30 days, then 75% of the use is rental (90 days out of 120 total days of use). You would allocate 75% of your maintenance, utilities, insurance, etc., costs to rental. You would allocate 75% of your depreciation allowance, interest, and taxes for the property to rental as well. The personal use portion of taxes is separately deductible. The personal use portion of interest on a second home is also deductible where (as is the case here) the personal use exceeds the greater of 14 days or 10% of the rental days. However, depreciation on the personal use portion isn't allowed.

If the rental income exceeds these allocable deductions, then you report the rent and deductions to determine the amount of rental income to add to your other income. If the expenses exceed the income you may be able to claim a rental loss. This depends on how many days you use the house for personal purposes.

Here's the test: if you use it personally for more than the greater of (a) 14 days, or (b) 10% of the rental days, you are using it "too much," and you cannot claim your loss. In this case, you can still use your deductions to wipe out the rental income, but you cannot go beyond the income to create a loss. Any deductions you cannot use are carried forward and may be usable in future years. If you are limited to using deductions only up to the amount of rental income, you must use the deductions allocated to the rental portion in the following order: (1) interest and taxes, (2) operating costs, (3) depreciation.

If you "pass" the personal use test (i.e., you don't use the property personally more than the greater of the figures listed above), you must still allocate your expenses between the personal and rental portions. In this case, however, if your rental deductions exceed rental income, you can claim the loss. (The loss is "passive," however, and may be limited under the passive loss rules.)

Example: You rent a vacation home 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). So 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 thus disallowed. You can deduct only $8,000 of expenses (up to the rental income). You must first deduct the rental portion (75%) of the interest and taxes ($4,500 (75% of $6,000)), then 75% of the 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 of depreciation.

If you have any questions regarding the above discussed topic or any other tax matter, please feel free to give me a call at (562) 698-9891.

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