

### **(Vacation Home Deduction -- A Tax Guide)**

Do you own a vacation or second home that you can treat as:

- A personal home
- A business lodging complex
- Part personal home and part rental property
- Part personal home and part hobby rental
- A one-unit motel

If "yes," you will love this article because it will help you put more money in your pockets.

#### **What is a vacation home?**

Technically, tax law says a "vacation home" is a dwelling you use for both:

- Personal, and
- Rental purposes

A dwelling includes a house, apartment, condominium, mobile home, motor home, yacht, boat, recreational vehicle and similar property. To be a dwelling, the property must have basic living accommodations, like:

- Sleeping place
- Toilet
- Cooking facilities

Thus, any dwelling used for both personal and rental is a vacation home, subject to special tax law vacation-home rules. The dwelling does not have to be at the beach or in the mountains. Tax law makes the dwelling a vacation home when you have both rental and personal uses.

#### **What if I have no rental use?**

With no or even limited rental use, you do not have a vacation home. Instead, you have a business property, a personal home, or a combined business and personal use property.

#### **Business Use of Vacation Home**

Do you use your vacation dwelling *solely* for business lodging? If "yes," you escape the dreaded vacation-home rules and may deduct your business-lodging costs. The vacation-home section of the Internal Revenue Code says that nothing in the vacation-home section shall disallow any deduction for business travel (unless that travel is for the business of renting dwelling units).

This means that the IRS may not apply the vacation-home rules to deny a business travel deduction.

Congressional floor debates show that in appropriate circumstances, ownership of a home can qualify for deductible business lodging expenses. In fact, Members of Congress can deduct the business portion of their out-of-town lodging expenses while serving in the United States Congress. When Congress enacted the vacation-home rules, then Senator Bob Dole states that the new 280A(f)(4) provision "will clarify that the personal use rules of section 280A will not be construed to deny otherwise allowable business expenses for travel away from home."

This means that if you use your vacation home for business and never as a rental property, you do not consider the adverse impact of the vacation-home rules.

#### **Personal Use of Vacation Home**

**Rent or use by relatives:** Personal use is more than meets the eye. You have personal use of a vacation home when you rent to or allow user by a relative. The rent charged makes no difference. Paying and nonpaying relatives who use your vacation home complicate your deductions. Such relative use is personal use by you. For this purpose, your relatives include your:

- Mom and dad
- Brothers and sisters
- Sons and daughters
- Grandchildren and grandparents
- Spouse

**Planning tip:** Do not rent to relatives.

**Planning note:** Co-owners must count use by their relatives as use by themselves. Thus, if you own the vacation home with others, make sure you ask your co-owners for use not only by them but also by their relatives.

**Charitable use produces personal days:** No matter how much the charitable donor pays for use of your vacation home, the IRS counts the charitable use as personal use by you. If you donate a week of vacation-home use to your high school's annual auction, you have a week of personal use. It makes no difference what the successful bidder pays for that week of use.

**Double whammy:** Your charitable gift of the right to use your vacation home for the week does not produce a deductible contribution for you. The Regulations deny a charitable contribution deduction for a gift of the right to use property.

**Swaps produce personal use:** Similarly, you have personal use when you swap vacation homes with a friend or under an exchange agreement. Swaps and bargains produce personal days. You count as personal use of your vacation home, any days that you:

- Allow a person to use your unit under an agreement that lets you use another dwelling, or
- Charge less than fair rent.

**Example 1:** You and Nelson swap one week of vacation-home use. Nelson's use of your vacation home during the one-week swap counts as personal use by you.

**Example 2:** You charge the first baseman on your baseball team only 77% of the fair rent. The first baseman's use counts as personal use by you.

**Repair days do not equal days of personal use:** Tax law says that you do not use your vacation home on days when your principal purpose for such use is repair or maintenance. To qualify the day as a repair day, you must spend substantially full-time repairing or maintaining the vacation home.

**Example 1:** You arrive Thursday evening, after a long drive, but in time for a late dinner at the cottage. You spend a normal work day

on both Friday and Saturday getting the unit ready for rental. Your spouse relaxes. You depart Sunday, a little before noon. According to the IRS's examples, your principal purpose for that trip is maintenance. You do not count Thursday, Friday, Saturday, or Sunday as days of personal use.

**Example 2:** You own a mountain cabin that you rent in the summers. During the week you spend at the cabin, your family members work substantially full-time repairing the cabin. You spend about 3 to 4 hours a day helping, and the rest of the time on the lake fishing. According to the IRS, your family's principal purpose of that week's stay is maintenance.

**Beware of improvements:** The IRS tried to disallow Twohey's stays at his vacation home because he improved the property. The Tax Court ruled for Twohey and against the IRS. It appears that the IRS could try this tack again when it can make improvements the central issue.

#### **Vacation Home Rented Less Than 15 Days**

**Tax-free income:** If you rent your home for less than 15 days, you do not report the rental on your tax return. The income is tax free. You do not share it with the government.

**Planning tip:** Do you have an event coming to your area that might command high rents? Say there is a major golf tournament, Olympic event, or other activity that could allow you to rent at a high rate for a short period.

**Example:** You have a summer home on the beach next to a major golf tournament. You rent the home for \$10,000 a week for two weeks. You have \$20,000 of tax-free income.

#### **Vacation Home Rented for 15 Days or More**

**Personal use of summer home:** If you personally use your rental for even one measly day, you must allocate expenses between rental and personal use. The personal-use portion is explained later under deducting personal use of a vacation home. You deduct the rental portion under either the:

- Rental property rules, or
- Hobby rental rules

**Planning note:** The difference in tax benefit is significant. As a rental property, you might shelter other income with rental losses. As a hobby, you may not deduct a loss.

**Technical point:** The amount of personal use determines the classification of your summer home as a rental property or hobby rental. The rental part of your summer home is tax-defined rental property when your personal use is either:

- 14 days or less, or
- 10% or less of the days rented

**Example - rental:** You rent your summer home 260 days. You use it personally for 26 days. Ten percent of your summer home is a personal home. Ninety percent is a rental property.

**Example - hobby:** With 30 days of personal use, you have a hobby rental. You may not deduct losses on the hobby rental part.

#### **Vacation Home as a Hobby Rental**

**Allocation breaks for hobby rentals:** When your property falls in the hobby rental category, it means that the law treats the property primarily as a home with the rental activity simply a hobby. You get tax deductions for both the home and hobby activities. The combination opens a planning opportunity.

**Planning tip:** You might get huge tax breaks when you follow the *Bolton* case to make allocations between personal and hobby use. We noted instances where *Bolton* produced a 400% increase in deductions. Under *Bolton*, you allocate interest and taxes to hobby rentals by dividing rental days by total days in the year. This method surpasses the IRS's method where you allocate interest and taxes to hobby use by dividing rental days by total days of use for rental and personal purposes.

**Example:** You rent your summer cabin for 112 days and use it personally for 28 days. The IRS says that you must take 80% of your interest and taxes against the hobby. You deduct the remaining 20% as itemized deductions.

*Bolton* says that you must take 31% against the hobby and deduct 69% as itemized deductions. In effect, you free 49% of the hobby's deductions under the *Bolton* method. With \$15,000 of mortgage interest and taxes, *Bolton* gives you a \$7,350 deductions advantage.

#### **Vacation Home as a Rental Property**

**Allocation breaks for rental homes:** If tax law classes your summer home as a rental property, you should follow the IRS's allocation method to get the best breaks.

**Personal part of interest lost:** If tax law classes your vacation home as a rental property, any mortgage interest allocated to your personal use is nondeductible consumer interest (ouch!).

**Planning tip:** You reduce personal nondeductible interest when you follow the IRS's allocation method. With the IRS method, you push more deductible interest to the rental.

**Passive-loss rules:** Tax law disallows deductions for passive activity losses incurred by individuals, estates, trusts, closely held C corporations, and personal service corporations. The law defines a passive activity as (1) any activity that involves a business in which the taxpayer does not materially participate and (2) any *rental* activity. Under this rule, you may deduct passive losses only against passive income. You carry unused losses (called suspended losses) forward until you either use them or sell the property.

**Rental activity:** For purposes of the passive loss rules, a rental activity is any activity where payments are principally for the use of tangible property. Your vacation home is a rental activity if it is not a motel.

**\$25,000 break:** Tax rules grant a deduction break to individuals who own 10 percent or more of a real estate rental activity in which they *actively* participate. The break goes to taxpayers who earn less than \$150,000. This break allows passive loss deductions of up to \$25,000 for individuals who earn \$100,000 or less. The law reduces the \$25,000 rental loss maximum by 50 cents for each dollar over \$100,000. Thus, if you earn more than \$150,000, tax law eliminates this break for you.

**Seven-day rule:** Your vacation home may or may not be a rental activity. To be a rental activity, the average period of customer use must exceed 7 days. The IRS treats rentals that fail the 7-day test as business activities subject to the more restrictive material participation standards for deducting passive losses. In other words, the \$25,000 break is not available in cases where the average rental is for 7 days or less. However, the 7-day rule might make your vacation home a hotel with extra tax breaks.

#### **Real Estate Professionals Escape Passive Loss Rules**

**General rule:** Rental activities are passive activities. Other business activities are passive activities if you do not materially participate.

**Exceptions for real estate professionals:** Rental activities in which you materially participate during the year are not passive activities if, for that year, you were a real estate professional.

**Requirements:** You are a "real estate professional" if you spend:

- More than half your time, and
- More than 750 hours

In a business that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

**Example:** You sell real estate for a living. You meet the requirements of a real estate professional.

**Technical note:** The requirements above come from IRS Publication 17. Some tax advisors feel that IRS regulations do not cover real estate agents. We disagree. We think that the IRS included real estate agents in its IRS Publications on purpose.

**Special employee rule:** You may not count services performed as an employee as performed in a real property trade or business, unless you own more than 5% of the stock, capital, or profits of the employer.

**Married persons:** In a joint return, you meet the requirements for time spent performing services only if either you or your spouse separately satisfies the requirements. Do not count services performed by the other spouse