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Tax Issues Related to Renting Your Vacation Home

Do you own a second home in the mountains, or some other getaway location, or are you thinking about buying one? If so, then you may have thought about the possibility of renting it out. Though many people would never consider inviting renters into their vacation home, preferring to keep it for themselves and their family, doing so can offset some of the expenses related to the property, and you may even reap a tax benefit at the same time. Whichever route you choose to go, knowing all of the applicable tax rules regarding designated second homes helps you get the maximum financial benefit out of your asset, and keeps you from making tax filing errors.

If You Don't Rent Your Property - Depending upon your individual tax situation, a designated second home's acquisition mortgage interest may be able to be included as an itemized deduction. However, there is a limit on the amount of acquisition debt for a taxpayer's main residence and one additional home for which the interest is deductible. For a primary residence and second home acquired before December 16, 2017 that limit is $1,000,000 ($500,000 if filing married separate). After December 15, 2017 the limit is reduced to $750,000 (except that debt incurred before December 16, 2017 still falls under the $1,000,000 limit).

Real property taxes on your main and any number of additional homes are also deductible if you itemize deductions when figuring your regular tax, but not for the alternative minimum tax (AMT). However, even though itemized taxes include property tax, state income tax, and certain other taxes, the total amount allowed per year is limited to $10,000 ($5,000 if you are married and file a separate return from your spouse), so the deduction for some of your taxes may be limited.

If You Rent Your Property - The tax ramifications of renting out your designated second home are largely dependent upon the amount of time that it is rented out during the year: (1) fewer than 15 days, (2) 15 days or more and your personal use is 10% or less and (3) 15 days or more and your personal use is more than 10%.

- **Rented Fewer Than 15 Days** - When you rent out a dwelling unit that you use as a residence–whether it's your main home or a second home–for a period that is fewer than 15 days during the year, you do not report the income and cannot deduct any rental-related expenses. However, you are still able to continue writing off eligible mortgage interest and real property taxes as itemized deductions. **Used Personally But for Less Than the Greater of 15 Days or 10% of the Rental Days** – In this scenario, the home's use would be allocated into two separate activities: a rental home and a second home. Let's say that the home is used 5% for personal use; then 5% of the interest and taxes would be treated as home interest and taxes that can be deducted as an itemized deduction. The other 95% of the interest and taxes would be rental expenses, combined with 95% of the insurance, utilities, allowable depreciation and 100% of the direct rental expenses. The result can be a deductible tax loss, which would be combined with all other rental activities and limited to a $25,000 loss per year for taxpayers with adjusted gross incomes (AGI) of $100,000 or less. This loss allowance is ratably phased out when AGI is between $100,000 and $150,000. Thus, if your income exceeds $150,000, the loss cannot be deducted; it is carried forward until the home is sold or there are gains from other passive activities that can be used to offset the loss.

- **Personal Use Exceeds the Greater of 14 Days or 10% of the Rental Days** - For those whose personal use of the home is more than 10% of the amount of time that it is rented (or more than 14 days, whichever is greater), no rental tax loss is allowed. Let's assume that the personal use of the home is 20%. As for the remaining 80%, it is used as a rental. The rental income is first reduced by 80% of the taxes and interest. If, after deducting the interest and taxes, there is still a profit, the direct rental expenses (such as the rental portion of the utilities, insurance and any other direct rental expenses) are deducted, but not more than will offset the remaining income. If there is still a profit, you can take a deduction for depreciation of the building, furnishings, etc., but it is again limited to the remaining profit. **End result:** No loss is allowed, but any remaining profit is taxable. The personal 20% of the interest and taxes is deducted as an itemized deduction, subject to the interest, taxes and AMT limitations discussed earlier. Take note that if the rental income becomes less than the business portion of the interest and taxes, the balance of the interest and taxes is still treated as home mortgage interest and taxes.

If You Sell Your Vacation Home - Even if you use your vacation home to generate rental income, it is still considered to be a property for your personal use, and that means that once you sell it you are subject to taxation on any gains you realize. By contrast, if the sale results in a loss, you are not permitted to deduct any losses – at least not in the examples we've provided above. In some cases, a loss on a property can be broken down between the personal, nondeductible use and the business rental portion, which would be deductible.

If You Sell Your Home - When you sell your primary home, you are able to take advantage of what is known as the principal residence gain exclusion, but this is not true of designated second homes. The gain from the sale of a second home is taxable, but may be eligible for favorable capital gains tax rates in many cases. One important exception to this rule is when the taxpayer has occupied the second home as their primary residence for at least two of the five years immediately before the sale takes place. At no time during that two-year period can the home have been rented. When this is the case and the taxpayer hasn't applied the principal residence gain exclusion on the sale of another property in the previous two years, the taxpayer may be able to take the exclusion. Doing so would allow married homeowners (where both qualify) to exclude from their income up to $500,000 of the home's gain and single homeowners to exclude home sale gain of up to $250,000, except for depreciation of the home that has previously been deducted.

Other Issues - There are certain situations involving designated second homes that are particularly complex, such as homes that are converted from an investment property to a primary residence, or when they were acquired by tax-deferred exchange. In these instances, it is essential that you consult with this office in order to ensure that all appropriate planning is done to provide you with the ability to gain the most benefit.

If you rent out your property and provide additional services such as maid service, or rent it out for short-term stays, the IRS may view that activity as a business operation rather than a rental. When this is the case the tax ramifications are entirely different. Because of this and many other complicating factors and exceptions it would be appropriate to contact this office to review the tax impact of all of your real estate transactions.

Taxes and Divorce

If you are recently divorced or are contemplating divorce, you will have to deal with or plan for significant tax issues such as asset division, alimony, and tax-return filing status. If you have children, additional issues include child support; claiming of the children as dependents; the child, child care, and education tax credits; and perhaps even the earned income tax credit

(EITC).

Filing Status – Your filing status is based on your marital status at the end of the year. If, on December 31, you are in the process of divorcing but are not yet divorced, your options are to file jointly or to each submit a return as married filing separately. There is an exception to this rule; however, if a couple has been separated for all of the last 6 months of the year, and if one taxpayer has paid more than half the cost of maintaining a household for a qualified child, then that spouse can use the more favorable head of household filing status. If each spouse meets the criteria for that exception, they can both file as heads of household; otherwise, the spouse who doesn't qualify must file using the status of married filing separately. If your divorce has been finalized on or before December 31 and if you haven't remarried, your filing status will be single or, if you meet the requirements, head of household.

Claiming the Children as Dependents – A common (and commonly misunderstood) issue for those who are divorced or separated and who have children is the choice regarding who claims a child for tax purposes. This can be a hotly disputed issue between parents; however, tax law includes very specific (albeit complicated) rules about who profits from child-related tax benefits. At issue are a number of benefits, including the child, child care, higher-education tuition, and earned income tax credits, as well as, in some cases, filing status.

This is actually one of the most complicated areas of tax law, and both taxpayers and inexperienced tax preparers can make serious mistakes when preparing returns, especially if the parents are not communicating well. When parents cooperate with each other, they often can work out the best tax result overall, even though it may not be the best for them individually, and can then compensate for discrepancies in other ways.

When a court awards physical custody of a child to one parent, the tax law is very specific in awarding that child's dependency to the parent who has physical custody, regardless of the amount of child support that the other parent provides. However, the custodial parent may release the dependency to the noncustodial parent by completing the appropriate IRS form.

CAUTION – The decision to relinquish dependency should not be taken lightly, as it impacts a number of tax benefits.

On the other hand, if a court awards joint physical custody of a child, only one of the parents can claim the child for tax purposes. If the parents cannot agree on who will claim the child, or if both actually claim the child, the IRS tiebreaker rules apply. Per these rules, a child is treated as a dependent of the parent with whom the child resided for the greater number of nights during the tax year; if the child resides with both parents for the same amount of time, the parent with the higher adjusted gross income claims the child as a dependent.

These rules take precedence over what a court may intend. For example, say the judge in Tom and Becky's divorce proceeding rules that Tom, who is required to pay a specified amount of child support monthly, is to claim their child as a dependent on his tax return. But the child lives with Becky more nights during the year than with Tom. Under the tax law, Becky is allowed to claim the child as her dependent, regardless of what the court-approved divorce agreement says.

Child's Exemption – Under prior law, a child's tax-exemption deduction was generally an issue; the parent claiming the child as a dependent got a deduction for the exemption allowance amount. However, because of tax reform, the tax deduction for such exemptions has been suspended through 2025; although this is no longer an issue for this benefit, a child's dependency is still a consideration for other tax issues.

Head of Household Filing Status – An unmarried parent can claim the more favorable head of household (rather than single) filing status if that person (a) is the custodial parent and (b) pays more than one-half of the cost of maintaining the household that is the principal place of residence for the child (i.e., where the child lives for more than half of the year).

Tuition Credit – If the child qualifies for either of two higher-education tax credits (the American Opportunity Tax Credit [AOTC] or the Lifetime Learning Credit), the credit goes to whomever claims the child as a dependent. Credits are significant tax benefits because they reduce the dollar-for-dollar tax bill; deductions, on the other hand, reduce taxable income before the tax amount is calculated according to the individual's tax bracket. For instance, the

AOTC provides a tax credit of up to $2,500, 40% of which is refundable. However, both education credits phase out for high-income taxpayers and effective for years after 2020 both credits phase out between $80,000 and $90,000 for unmarried taxpayers and between $160,000 and $180,000 for married taxpayers.

Child Care Credit – A nonrefundable tax credit is available to the custodial parent to offset the cost of child care, provided that the parent is gainfully employed or seeking employment. To qualify for this credit, the child must be under the age of 13 and be a dependent of the parent. However, there is a special rule for divorced or separated parents; when the custodial parent releases the child's exemption to the noncustodial parent, the custodial parent still qualifies for the child care credit, and the noncustodial parent cannot claim that credit. The credit is a percentage of the expenses and ranges from 35% for lower income taxpayers to 20% for the higher income ones. The expenses used to determine the credit are limited to $3,000 for one child and $6,000 for two or more. Note: A substantial one year (2021) increase in the credit is included in President Biden's American Rescue Plan.

Child Tax Credit – A credit of $2,000 is allowed for each child under the age of 17. This credit goes to the parent who claims the child as a dependent. Up to $1,400 of the credit is refundable if the credit exceeds the tax liability. However, this credit phases out for high-income parents, beginning at $200,000 for single parents and at $400,000 for married parents filing jointly. President Biden's American Rescue Plan also includes a one-year increase to $3,000 ($3,600 for children under the age of 6).

Earned-Income Tax Credit – Low-income parents with earned income (either wages or self-employment income) may qualify for the EITC, which is based on the number of children (all those under age 19, plus full-time students under age 24), up to a maximum of three children. Releasing dependency to the noncustodial parent does not disqualify the custodial parent from using children to qualify for the EITC. In fact, the noncustodial parent is prohibited from claiming the EITC based on children whose dependency the custodial parent has released.

Alimony – The tax reforms enacted in late 2017 also impact the tax treatment of alimony. For divorce agreements that were finalized before the end of 2018, the recipient (payee) of the alimony must include that income for tax purposes. The payer in such cases is allowed to deduct the payments above the line (without itemizing deductions); this is technically referred to as an adjustment to gross income. The recipient who includes this alimony income can treat it as earned income for purposes of qualifying for an IRA contribution, thus allowing the recipient to contribute to an IRA even if he or she has no income from working.

Because some of those who make alimony payments will claim that they paid more than they actually did, and because some recipients will report less alimony income than they actually received, the IRS requires that the paying spouse's tax return include the recipient spouse's Social Security number so that the IRS can use a computer to match the amount received to the amount paid.

For divorce agreements that are finalized after 2018, alimony is not deductible by the payer and is not taxable income for the recipient. Because the recipient isn't reporting alimony income, he or she cannot treat it as earned income for the purposes making an IRA contribution.

This revised treatment of alimony also applies to any divorce or separation instrument that is executed before the end of 2018 but modified after that date – if the modification expressly provides that the tax reform provisions apply.

As you can see, some complex rules apply to divorce situations. Please consult this office if you have any questions related to a pending divorce action. Please note that, if this office has been providing services to both parties in a pending divorce, there are some inherent conflicts of interest in providing advice or preparation services to both parties, so this office may be able to provide services to only one member of the former couple.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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