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Vacation Home Rentals: How the Income Is Taxed

If you have a second home in a resort area, or if you have been considering acquiring a second home or vacation home, and with summer just around the corner, 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 as part of itemized deductions and within the usual limitations. 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 or during a major sports event such as the Super Bowl.
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 may be deductible 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). If the rental income less the expenses result in a loss, the loss is limited to $25,000 per year for a taxpayer with adjusted gross income (AGI) of $100,000 or less and is ratably phased out when AGI is between $100,000 and $150,000. Thus, if a taxpayer's income exceeds $150,000, the rental loss cannot be deducted; it is carried forward until the home is sold or until there is rental profit in a future year or the taxpayer has gains from other passive activities that 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, if he or she has not used that exclusion for another property in the prior two years. As a result, 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.

When Can You Destroy Old Tax Records?

Taxpayers often question how long records must be kept and the amount of time IRS has to audit a return after it is filed.

It all depends on the circumstances! In many cases, the federal statute of limitations can be used to help you determine how long to keep records. With certain exceptions, the statute for assessing additional tax is 3 years from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states is one year longer than the federal limitation. The reason for this is that the IRS provides state taxing authorities with federal audit results. The extra time on the state statute gives states adequate time to assess tax based on any federal tax adjustments that also apply to the state return.

In addition to lengthened state statutes clouding the recordkeeping issue, the federal 3-year rule has several exceptions:

- The assessment period is extended to 6 years instead of 3 years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return.
- The IRS can assess additional tax with no time limit if a taxpayer: (a) doesn’t file a return; (b) files a false or fraudulent return to evade tax; or (c) deliberately tries to evade tax in any other manner.
- The IRS gets an unlimited time to assess additional tax when a taxpayer files an unsigned return.

If no exception applies to you, for federal purposes, you can probably discard most of your tax records that are more than 6 years old; add a year or so to that if you live in a state such as Colorado with a longer statute.

Important note: Even if you discard tax backup records, never throw away your records that relate to an asset you still own. This might include the return itself since it often provides data that can be used in future tax return calculations or to prove amounts related to property. You should keep certain records for longer than 7 years. These records include:

- **Stock acquisition data.** If you own stock in a corporation, keep the purchase records for at least 4 years after the year you sell the stock. This data will be needed to prove the amount of profit (or loss) you had on the sale. Although brokers are now required in most cases to keep purchase records and report the information to the IRS when the stock is sold, it is still a good idea for you to maintain your own records, as you the taxpayer are ultimately responsible for proving the cost to the IRS if your return is audited.

- **Stock and mutual fund statements where you reinvest dividends**. Many taxpayers use the dividends they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to basis in the property and reduce gain when it is finally sold. Keep statements at least 4 years after the final sale.

- **Tangible property purchase and improvement records.** Keep records of home, investment, rental property, or business property acquisitions AND related capital improvements for at least 4 years after the underlying property is sold.

As we become more and more a paperless society, you may wonder if you must keep the paper version of the records mentioned in this article. No, you don't – the paper documents can be scanned and maintained on your computer or in the cloud. But if you do convert the records to electronic files, be sure to maintain a back-up that can be retrieved if you have a computer crash or cyber attack that takes over your computer.

If you have questions about what records to retain and what you can dispose of now, please give this office a call.

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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