

Tax Treatment of Vacation and Second Homes

Important Note: *Real estate professionals must be careful not to stray into the area of delivering legal or tax advice. Advise clients and customers to seek professional advice with respect to specific situations.*

The tax treatment of a vacation or second home is different from that of a personal residence. The determining factors are the amount of time the property is rented, the extent of the owner's occupancy, and the owner's intent, such as holding the property for investment.

The "14-day rule" is very important for owners of vacation and second homes rented part time; it is the basic IRS rule that determines the tax treatment of the property. If specialists know that prospective buyers plan to rent a vacation home part of the time, they should make the buyers aware of this rule. It should be incorporated into expectations for the property from both a financial and personal enjoyment standpoint.

Following are basic provisions of the rule:

- If a second home is never occupied by the owner, the IRS will regard it as a rental property, if it is rented year round, or as an investment property, if it is not rented.
- If the property is owner-occupied part time and rented for less than fourteen days in a year, the owner is not required to report the rental income. It should be obvious that no tax deductions can be claimed for the property's expenses or upkeep if no income is reported from it.
- If the property is owner-occupied for more than fourteen days or 10 percent of the time it was rented (whichever is greater), it is ~~considered a personal residence~~. Time spent working on, repairing, maintaining, and improving the property is not considered in the 14-day usage.
- If a property is rented for more than fourteen days, all rental income must be reported. Income may be offset with deductions for the rent-related portions of expenses such as utilities, maintenance, and upkeep; a depreciation deduction may also be claimed against the rental income.



Discussion Question

Colleen owns a mobile home which she occupies for fourteen days of the calendar year. She rents the mobile home at fair rental for 183 days of the calendar year. Does Colleen's mobile home qualify as a rental property and why?

Deductible Expenses

Personal Residence

- Interest on mortgage debt, points, and fees
- Real estate taxes
- Casualty and theft losses

Rental Property

- Interest on mortgage debt, points, and fees
- Real estate taxes
- Casualty and theft losses
- Depreciation
- Advertising
- Cleaning, repairs, and maintenance
- Insurance
- Commissions
- Tax preparation fees
- Travel and local transportation expenses

An improvement that increases the value of a property is added to its basis; some examples are building additions, landscaping, installing new heating or air conditioning, new plumbing, and remodeling among others. The cost of the property and improvements are recovered through deductible depreciation allowances. The schedule for determining yearly

deductions is termed the Modified Accelerated Cost Recovery System (MACRS). Real property is depreciated over a period of 27.5 years. Only structures may be depreciated; land is never depreciable. Cost recovery deductions claimed during the time of ownership are recaptured at the time of sale and are taxed at the rate of 25 percent.

Prorating Expenses

If a property is used for both rental and personal purposes, the expenses are divided between the rental use and the personal use based on the number of days used for each purpose. The IRS rule for dividing expenses is as follows:

- Any day that the unit is available for rent but not actually rented is not a day of rental use.
- Any day that the unit is rented at a fair rental price is a day of rental use even if the unit was used for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
- Personal usage includes all days that the dwelling unit is used by any of the following parties: the taxpayer or any person who has an interest in the vacation home, any member of any owner's family, anyone who uses the property as part of a home exchange, or anyone who occupies the property at less than fair market rental unless the occupant is an employee and the lodging is furnished for the convenience of the employer.

Vacation-home owners should consult a tax professional about prorating expenses. The right pattern of usage depends largely on factors such as the owner's vacation schedule, how much can be made by renting the unit to others, and how much can be realized on a net basis after expenses. Some tax professionals go so far as to recommend that the owner never occupy the property, even for maintenance or repair purposes; because it can be difficult to document the extent and purpose of owner-occupancy, they recommend that the owner stay in a hotel. On the other hand, owners of beach and ski resort properties or homes in seasonably desirable locations, such as Louisville during Derby Week or New Orleans during Mardi Gras, can reap a tax-free windfall by renting their properties for seven weekends or a short length of time; daily rentals for these highly desirable properties and time-frames can easily run several hundred dollars a day.

6. Tax and Investment

SCHEDULE E
(Form 1040)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships,
S corporations, estates, trusts, REMICs, etc.)

OMB No. 1545-0074

05

Department of the Treasury
Internal Revenue Service (20)

▶ Attach to Form 1040 or Form 1041. ▶ See instructions for Schedule E (Form 1040).

Attachment
Sequence No. 13

Name(s) shown on return

Your social security number

Part I **Income or Loss From Rental Real Estate and Royalties** Note: If you are in the business of renting personal property, use Schedule C or C-EZ (see page E-3). Report farm rental income or loss from Form 4835 on page 2, line 40.

1	List the type and location of each rental real estate property:	2	For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:	Yes	No
A	<ul style="list-style-type: none"> • 14 days or • 10% of the total days rented at fair rental value? (See page E-3.) 	A		
B		B		
C		C		

		Properties			Totals (Add columns A, B, and C.)
		A	B	C	
Income:					
3	Rents received	3			3
4	Royalties received	4			4
Expenses:					
5	Advertising	5			
6	Auto and travel (see page E-4)	6			
7	Cleaning and maintenance	7			
8	Commissions	8			
9	Insurance	9			
10	Legal and other professional fees	10			
11	Management fees	11			
12	Mortgage interest paid to banks, etc. (see page E-4)	12			12
13	Other interest	13			
14	Repairs	14			
15	Supplies	15			
16	Taxes	16			
17	Utilities	17			
18	Other (list) ▶	18			
19	Add lines 5 through 18	19			19
20	Depreciation expense or depletion (see page E-4)	20			20
21	Total expenses. Add lines 19 and 20	21			
22	Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file Form 6198.	22			
23	Deductible rental real estate loss. Caution. Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file Form 8582. Real estate professionals must complete line 43 on page 2	23			
24	Income. Add positive amounts shown on line 22. Do not include any losses	24			
25	Losses. Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25			
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2	26			

Rental income and expense are reported on Schedule E.

Passive Activity Limits

The distinctions between passive activity, active participation, and material participation are important for tax treatment of a property because they determine the limits of deductible losses, the extent of deductible passive activity losses that can offset other income, and carryover of losses to subsequent years. The amount of time and level of involvement documented determines whether the level of activity is passive, active, or material. Obviously, it is possible for a taxpayer to have large financial interest in a business but not actively or materially participate.

Passive Activity

"At Risk" rules limit the amount an owner can deduct as losses. Deductions for losses from passive activities are limited to the amount of income generated from the activity itself; other income cannot be offset with losses from passive activity. Excess loss can be carried forward to the next year. **In general, all real estate rental activity is considered passive in nature for tax purposes.** Credits and losses from passive income activities including rental of real estate can only be deducted or carried over against passive income. Any remaining losses are counted when the passive activity is sold for a loss or gain.

Active Participation

Active participation requires a minimum 10 percent ownership of the rental property and management-level decision making, such as approving new tenants, deciding on rental terms, approving expenditures, reviewing expenses, and so forth. Work done by the owner in the capacity of an investor is not considered active participation.

If the owner, or spouse, actively participates in a real estate activity then up to \$25,000 of loss from the passive activity can be used to offset other income. The \$25,000 deduction is phased out if the taxpayer's modified adjusted gross income (MAGI) is between \$100,000 and \$150,000; the deduction is phased out by \$1 for every \$2 earned over \$100,000.

If a management firm is involved in the day-to-day operation of a rental unit, it is still possible to prove active participation if management decisions, such as those noted above, are made by the owner; it is important to check that the terms of the rental agreement do not characterize the owner's participation as "not material" or "not active."

Material Participation

Material participation is defined as work that is a regular, continuous, and substantial involvement in operations. Each interest in rental real estate is considered a separate activity unless the taxpayer chooses to treat all rental interests as one activity.

If the owner, or spouse, actively participates in a real estate activity, then up to \$25,000 (\$12,500 if married filing separately) of loss from the passive activity can be used to offset other income. The \$25,000 deduction is phased out if the taxpayer's modified adjusted gross income is between \$100,000 and \$150,000; the deduction is phased out by \$1 for every \$2 earned over \$100,000. Short-term rentals do not qualify for the \$25,000 exception to the passive loss rule for rental real estate.

The difference between active participation and material participation is that the active participation test can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates in the making of management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense. Material participation is a year-by-year determination; a taxpayer's level of activity could be passive in one year and non-passive (actively or materially participating) in the next year.

Considerations for Real Estate Professionals



Specialists who own rental property should carefully note that the IRS views real estate professionals as material participants in rental real estate activities. As noted above, generally, rental activities are passive in nature even if the taxpayer participated materially. However, if a taxpayer qualifies as a real estate professional, rental real estate activities in which the taxpayer materially participates are not considered passive. A real estate professional is someone who meets both of the following criteria:

- More than half of the taxpayer's personal services are performed in real property businesses.
- More than 750 hours are spent in real property businesses in which the taxpayer materially participates.

If a joint return is filed, the same taxpayer must materially participate in the real property businesses and pass both tests mentioned above. A spouse's personal services cannot be counted to determine if the criteria are met.

Alternative Minimum Tax

Although Alternative Minimum Tax (AMT) is not directly related to taxation of income from property, it can become a factor for the upper-income taxpayers who are likely to own investment homes. When added to income from salaries and other investments, the income and stream of tax deductions from the rental property can trigger the AMT. Specialists must be aware of this tax situation and recommend that buyers consult a tax professional about it.

The AMT is a parallel tax system introduced in the 1960s. Unlike the regular tax code which is progressive, the AMT is a flat tax of 26 or 28 percent. It is intended to ensure that the wealthiest taxpayers pay a fair share of taxes by reducing the amount of deductions they can claim. However, since its inception, the AMT has not been indexed for inflation, as other tax rates have been; therefore, as incomes have risen to keep up with inflation, more middle-income taxpayers have been trapped by AMT obligations. According to the Congressional Budget Office, prior to 2000, less than 1 percent of taxpayers were impacted by AMT; however, because it is not indexed for inflation, it is estimated that 20 percent of taxpayers will be impacted by 2010.

The AMT system requires affected taxpayers to calculate their liability using both the regular indexed tax rates and the AMT rates and pay the higher of the two amounts. Taxable income under the regular tax system can be reduced through personal exemptions and standard or itemized deductions. AMT does not allow these deductions including the mortgage interest deduction starting in 2006; instead, it provides for a large overall exemption which is phased out above certain income levels by \$.25 for every dollar above a specified level.

Alternative Minimum Tax Exemptions and Phase-Out Ranges		
Filing Status	2005	2006
Married filing separately	Exemption: \$29,000 Phased out: \$75,000 – \$191,000	Exemption: \$22,500 Phased out: \$150,000 – \$330,000
Married filing jointly or for a surviving spouse	Exemption: \$58,000 Phased out: \$150,000 – \$382,000	Exemption: \$45,000 Phased out: \$150,000 – \$330,000
Single or head of household	Exemption: \$40,250 Phased out: \$112,500 – \$273,500	Exemption: \$33,750 Phased out: \$112,000 – \$247,000

6. Tax and Investment

<p>Form 6251 Rev. January 2000 Department of the Treasury Internal Revenue Service (100)</p>	<p>Alternative Minimum Tax—Individuals ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1040NR.</p>	<p>OMB No. 1545-0047 05 Attachment Sequence No. 32 Your social security number</p>
<p>Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)</p>		
<p>1 If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41 minus any amount on Form 9914, line 21, and go to line 2. Otherwise, enter the amount from Form 1040, line 38 minus any amount on Form 9914, line 21, and go to line 2. If less than zero, enter as a negative amount.</p>	1	
2 Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4, or 2% of Form 1040, line 1A.	2	
3 Taxes from Schedule A (Form 1040), line 9.	3	
4 Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet on page 2 of the instructions.	4	
5 Miscellaneous deductions from Schedule A (Form 1040), line 26.	5	
6 If Form 1040, line 38, is over \$145,050 (over \$72,075 if married filing separately), enter the amount from line 9 of the Itemized Deductions Worksheet on page 4-9 of the instructions for Schedules A & B (Form 1040).	6	
7 Tax refund from Form 1040, line 10 of line 21.	7	
8 Investment interest expense difference between regular tax and AMT.	8	
9 Depreciation difference between regular tax and AMT.	9	
10 Net operating loss deduction from Form 1040, line 21. Enter as a positive amount.	10	
11 Interest from specified private activity bonds exempt from the regular tax.	11	
12 Qualified small business stock (7% of gain excluded under section 1202).	12	
13 Exercise of incentive stock options excess of AMT income over regular tax income.	13	
14 Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A).	14	
15 Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6).	15	
16 Depreciation of property difference between AMT and regular tax gain or loss.	16	
17 Depreciation on assets placed in service after 1985 (difference between regular tax and AMT).	17	
18 Passive activities (difference between AMT and regular tax income or loss).	18	
19 Loss limitations (difference between AMT and regular tax income or loss).	19	
20 Circulation costs (difference between regular tax and AMT).	20	
21 Long-term contracts (difference between AMT and regular tax income).	21	
22 Mining costs (difference between regular tax and AMT).	22	
23 Research and experimental costs (difference between regular tax and AMT).	23	
24 Income from certain installment sales before January 1, 1987.	24	
25 Intangible drilling costs preference.	25	
26 Other adjustments, including income-based related adjustments.	26	
27 Alternative tax net operating loss deduction.	27	
28 Alternative minimum taxable income. Combine lines 1 through 27. If married filing separately and line 25 is more than \$191,000, see page 7 of the instructions.	28	
<p>Part II Alternative Minimum Tax</p>		
<p>29 Exemption. If this form is for a child under age 14, see page 7 of the instructions.</p>		
<p>IF your filing status is . . . AND line 28 is not over . . . THEN enter on line 29 . . .</p> <p>Single or head of household . . . \$112,500 . . . \$0,250</p> <p>Married filing jointly or qualifying widow(er) . . . 150,000 . . . 50,000</p> <p>Married filing separately . . . 75,000 . . . 25,000</p> <p>If line 28 is over the amount shown above for your filing status, see page 7 of the instructions.</p>		
30 Subtract line 29 from line 28. If zero or less, enter -0- here and on lines 31 and 35 and stop here.	30	
31 • If you reported capital gain distributions directly on Form 1040, line 13, you reported qualified dividends on Form 1040, line 9b, or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) as returned for the AMT, if necessary, complete Part III on the back and enter the amount from line 55 here. • All others: If line 30 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.	31	
32 Alternative minimum tax (foreign tax credit—see page 7 of the instructions).	32	
33 Tentative minimum tax. Subtract line 32 from line 31.	33	
34 Tax from Form 1040, line 44 minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 47. If you used Schedule J to figure your tax, the amount for line 44 of Form 1040 must be reduced without using Schedule J (see page 9 of the instructions).	34	
35 Alternative minimum tax. Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45.	35	
36 Subtract line 35 from line 33. If zero or less, enter -0-.	36	
37 Enter the smaller of line 36 or line 37.	37	
38 Enter the smaller of line 45 or line 46.	38	
39 Multiply line 37 by 50% (.50).	39	
40 Subtract line 39 from line 46.	40	
41 Multiply line 40 by 15% (.15).	41	
42 If line 38 is zero or blank, skip lines 43 and 44 and go to line 45. Otherwise, go to line 43.	42	
43 Subtract line 43 from line 40.	43	
44 Multiply line 43 by 25% (.25).	44	
45 Add lines 42, 48, 50, and 52.	45	
46 If line 45 is \$175,000 or less (\$87,500 or less if married filing separately), multiply line 45 by 26% (.26). Otherwise, multiply line 45 by 28% (.28) and subtract \$3,500 (\$1,750 if married filing separately) from the result.	46	
47 Enter the smaller of line 45 or line 47 here and on line 31.	47	