Magic Number 14

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Do you know whether your second home is considered a personal residence, vacation home, or a rental property by the IRS? It all depends on how many days you use it.

Summer is here and school is out, are you prepared to rent your vacation property? Depending on how you use your property, tax treatment rules will vary greatly. In general, for tax purposes, properties are either categorized as primary (principal) residences, second (vacation) homes, or rental properties. Property owners are usually familiar with reporting taxes on principal residences and rental properties. However, when it comes to a second home used for both personal and rental purposes, the tax laws can be difficult to follow. Below is the breakdown of the basic rules in their simplest form.

Depending on how a second home was used in a given year, it will be categorized as one of the following: personal residence with minimal rental use, vacation home, or rental property with minimal personal use.

However, these categories are not finite for tax purposes; the same home can be considered a personal residence one year and a vacation home the next year. It all depends on the purpose for which the property was used and how many days it was used for that purpose during a specific calendar year.

First, let's determine the difference between personal use and rental use, according to the Internal Revenue Code §280A (IRC). Personal use days are the days a residence is used by or for: the owner as a second residence; immediate family members or lineal descendants of the owner, even if they pay rent, as long as they do not use the property as their primary residence for any period of time; others who swap the use of their houses at a fair rental price; anyone who rents the residence at substantially less than the going rental price; and charitable purposes.

Rental days are the days others rent the residence at a fair rental price. When a property owner uses his or her residence to do or manage maintenance or repairs, these days are neither personal use days nor rental days.

Personal Residence with Minimal Rental Use

Under federal tax code IRC §280A, owners can benefit from a short-term rental option that does not require reporting income. First, the property owner must determine whether or not one's home is a personal residence or rental property. If it is a personal residence, the property owner can plan ahead to make sure the home meets the tests to exclude the rent collections from gross income. Keep in mind, though, that there still could be state and local tax obligations on the rents collected.

The property will be treated as a personal residence with minimal rental use, during the tax year, if the following tests are met: the residence is rented out *14 days or fewer* during the tax year, and the residence's personal use days exceed the greater of 14 days or 10% of days rented out during the year.

Since income is excluded, the expenses related to renting the property are disallowed. However, property tax and *qualified* mortgage interest (if not limited) are still allowed for deduction on the homeowner's personal income tax return Schedule A.

Let's look at an example. Let's say Jill owns a home in San Francisco and a second residence in South Lake Tahoe. She uses the Tahoe house whenever she can and occasionally rents it out during holidays. During 2015, the property was rented out for 10 days. Jill's personal use of the property was 30 days. In this example, Jill meets both tests. She rented out her second residence 14 days or fewer, and she used the property more than 14 days or 10% of rental days, whichever is greater (in this case 14 days).

On her 2015 tax return, Jill does not report the $4,000 rental income she received. However, unlike a rental property, she is not entitled to deduct any of the cleaning, maintenance, or advertising expenses. She only claims property tax payments on her Schedule A. Neither is she eligible to deduct the mortgage interest, because her average mortgage balance for 2015 on her San Francisco principal residence exceeded the loan indebtedness threshold ($1.1 million).

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Therefore, mortgage interest on her Tahoe home is not qualified residential interest.

Since Jill decided not to report that income, it may cause her a headache with the IRS. What happens if Jill receives a 1099-Misc form (or 1099-K) for the rents she received, after she decided to not report that income? Airbnb, for example, sends out 1099 forms to homeowners who use its service to rent out their homes during the year.

The IRS definitely will compare what Jill reports on her tax return to what was reported by third parties and send an automatically generated notice to resolve an income deficiency. And while Jill is resolving the income deficiency, a second and third automatically generated notice (regarding the follow up actions, such as notice to levy) may come if the first notice isn't handled promptly and properly.

We would recommend that Jill take a preventative measure and attach a statement that includes the income per the 1099 form with her tax return. A tax professional can help to ensure the income is shown and backed out correctly. Of course, good recordkeeping of personal and rental use days is always important since this is an exception to the income reporting.

Vacation Homes

The vacation home tax rule applies when a residence is rented out for *more than* 14 days, and it is also used personally (not as a principal residence) the greater of 14 days or 10% of days rented out during the year. In this tax situation, a taxpayer is generally required to report the rental income and allowed to deduct certain rental expenses on Schedule E.

These deductions are allowed in the following order to the extent of the gross rental income: prorated rental portion of the mortgage interest, property taxes, and casualty loss; costs directly incurred to renting out the residence; and depreciation deduction.

If total allowable deductions exceed the total rental income, then the losses can be carried over to future years until there are rental profits to offset. If the vacation home is sold before the excess loss is used up, then the loss is lost.

The allocation method of expenses that are regularly deductible on Schedule A (property taxes, mortgage interest, and casualty losses) varies. The IRS allows the use of a consistent method for all deductible expenses based on the number of days of each use, but some court decisions disallowed this method. Instead, the allocation method was based on total rental days divided by 365 days, instead of total use days. However, prorating expenses that are not regularly deductible on Schedule A is based on the number of days of each use, ignoring vacant days.

Let's take Jill's example again and change the rental days to 15 days and personal use days to 35 days. Jill reports her rental income and deducts the rental portion of her property taxes, mortgage interest, cleaning costs, insurance and utilities, total commissions paid to rental agents, and allocable depreciation deduction on Schedule E of her tax return. She is allowed to deduct the personal portion of the property taxes on Schedule A of her tax return. Since her San Francisco principal residence mortgage interest is limited, she is not allowed to deduct the personal portion of the interest on her Schedule A. Any excess loss is carried forward to future years.

Rental Property with Minimal Personal Use

What is the tax treatment if the personal use days do not exceed the greater of 14 days or 10% of days rented out? In this case, the residence is considered a rental property subject to passive loss limitations. The rental activity is reported on Schedule E of a taxpayer's personal income tax return. There is no ordering rule for deductions like there is for a vacation home.

Although this type of use pattern would still categorize residences as a rental property, taxpayers still need to remove the personal use portion of the expenses. The personal portion of property taxes is allowed for deduction on Schedule A. However, the personal use portion of the mortgage interest is not deductible per the IRC §163. To be deductible, a residence would have to be considered a personal residence with personal use exceeding 14 days or 10% of days rented out. If a taxpayer wants to deduct the personal use portion of interest, the personal use days should increase so that the vacation home rule applies instead of the rental property rule.

Let's continue with Jill's example. Jill rents out her Tahoe home the entire year except for 14 days during ski season. Her personal use days did not exceed 14 days or 10% of days rented out. Therefore, her Tahoe home is a rental property. She reports rental income and the rental portion of deductions on Schedule E of her tax return. She will deduct the personal portion of the property taxes (14 days/365 days) on her Schedule A.

Since she actively participates (but not material participation) in the rental activity, she is allowed to deduct rental loss up to $25,000. If her income limits the deductions, she will carry forward the loss.

Vacation Home Last Year and Rental Property This Year

What if Jill's second home was categorized as a personal use vacation home the previous year, but now she wants to use it as a full-time rental property?

The same home can be subject to different tax rules depending on how the property was used previously. Conversion from a personal residence to a vacation home or a rental property is not complicated. However, complication arises when a vacation home with carryforward loss becomes a rental property and the rental property does not generate net rental income.

The good news is any loss that arose from a vacation home can be used in the rental property period, provided there is net rental income where the loss can be used up.

It does get complicated if the rental property has a loss also, then, the loss from the vacation home is carried forward and tracked separately. Earlier we mentioned that a taxpayer may deduct up to a $25,000 loss if he or she actively participates in the management of the property. Unfortunately, this applies only to the loss generated while the property is considered a rental property subject to IRC §469 passive activity loss rule. The vacation home loss is subject to IRC §280A limitations. Therefore, a taxpayer will have to track the two losses separately.

With national elections approaching, the tax overhaul continues to be the most publicized topic among the nominees and lawmakers, so these laws could be subject to change. It will be interesting to see what last-minute decisions will be made in such a short window by lawmakers. After all, bills signed at the last minute have become somewhat of a trend.

Remember, if you want to optimize short-term rental opportunities in your personal use residence, be sure to limit the days rented out to 14 days or fewer. For those considering converting their vacation homes to rental properties, be sure to limit the personal use days to 14 days or fewer to allow maximum deductions. Either way, meticulous recordkeeping is extremely important.

The above is the basic rule in its simplest form for general information purposes; as such, it is not an authority to rely on in making tax decisions. Consulting with your tax advisors is highly recommended.

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Know Your numbers

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