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In this article, Epstein explains the tax consequences to consider before purchasing a vacation home.

As summer nears, the thought of spending a few weeks or long weekends walking the boards at the beach or fishing lakeside inspires dreams of owning a vacation home. Why pay all that rent, you might say; let's buy our own place. Owning a second home at the shore or in the mountains might just be the perfect family escape. But just as often, thoughts revolve around how to make that second home pay for itself by either renting it out for a few weeks or by taking tax deductions. How do you make that dream a reality and what about the cost?

Is Rent Income?

The short answer is yes — rent is income — with a "but" that follows. If your vacation home is rented for fewer than 15 days of the year, rent is not included in taxable income, and no deductions will be allowed for expenses related to its rental.[1]

Deducting Mortgage Interest Payments

Mortgage interest might be deductible under the right circumstances. Ordinarily, there are no tax deductions allowed for expenses related to a residential property aside from a now-limited mortgage interest and real estate tax deduction of up to $10,000 annually. For tax years 2018 through 2025 only qualified residential interest is deductible on acquisition indebtedness.[2] The mortgage interest deduction is limited to a maximum of $750,000 for married taxpayers ($375,000 for married individuals filing separately) on acquisition indebtedness, which is debt incurred in acquiring, constructing, or substantially improving any qualified residence and which is secured by that residence.[3] What qualifies for substantially improving a residence? Expenses that add value, prolong useful life, or that adapt the residence to new uses. General maintenance does not qualify. What is a qualified residence? It is the principal residence of the taxpayer within the meaning of section 121 and one other residence of the taxpayer within the meaning of section 280A(d)(1).[4] In general terms, the other residence might be a vacation home, provided it is used for personal purposes for a period that exceeds the greater of 14 days or 10 percent of all rental days, and the owner files an election with the IRS to apply the qualified interest deduction rules for the second residence.

Example 1: Consider a situation in which a vacation home is used by the owner for 18 days and rented for 190 days. Ten percent of the rental period is equal to 19 days, which exceeds the actual owner usage. Because the actual usage of 18 days was less than 19 days (the greater of 14 days or 10 percent of 190 rental days), the owner's minimal usage would disqualify the home as a residence for the purpose of deducting mortgage interest. Conclusion: No mortgage interest deduction allowed.

Example 2: If in the prior example, the vacation home was used by the owner for 20 days

[1] Section 280A(g).

[2] Section 163(h); PMTA 2019-001; and section 164(b)(6).

[3] Section 163(h)(3)(F).

[4] Section 163(h)(4)(A)(i)(ll).

and rented for 190 days, the outcome then changes and the owner could take a mortgage interest deduction. Ten percent of all rental days is 19, which is greater than the 14 days allowed. Therefore, the owner's use of the vacation home for 20 days exceeds 19 days, allowing the vacation home to qualify as an "other" residence for mortgage interest deduction purposes.

Given this rule, a vacation homeowner had best either use more personal days or reduce the number of rental days. This requires advance planning to avoid an unexpected outcome. It might be advisable to keep a separate calendar marking the days of personal use and rental use. In the most extreme scenario, assuming the vacation home is rented out every day that the owner is not using it personally, the owner would have to use the vacation home for at least 34 days to preserve the mortgage deduction.

This still does not fully answer the question whether mortgage interest on a vacation home is deductible. Mortgage interest is only deductible if an owner acquires a vacation home by taking out a mortgage on that same home, subject to the limitations of the code. In comparison, if the owner borrowed against their primary home to purchase a vacation home, the mortgage interest would not be deductible. Under recent changes to the tax laws, for the time period between 2018 and 2025, if a second home is acquired with either a home equity line of credit or a second mortgage on a primary residence, the mortgage interest deduction is disallowed. The loan must be on the property that secures the loan.

Deducting Expenses

For a vacation home that is used for personal pleasure and is rented out for a few weeks or months during the year, the rule is to allocate deductible expenses to the rental portion of the year.[5] As previously mentioned, if a vacation home is rented for fewer than 15 days, the income is not reportable on the owner's tax return and no expenses related to the rental can be deducted. However, if a vacation home is rented for 15 days or more, it may be possible to deduct a portion of the expenses related to the rental and operation of the home.

Keep in mind that any days rented to relatives will still be considered personal use even if rented at fair market rates. A relative for this purpose is a spouse, sibling, half-sibling, parent, grandparent, child, and grandchild. Similarly, days rented to non-family members below fair market rental rates are also deemed personal use days. Days used substantially full time for repair and maintenance won't count as personal days.[6]

Example 3: A vacation home is used by the taxpayer for 10 days of the year and used by the taxpayer's child for 15 days. The vacation home is also rented to a stranger for 20 days at below fair market rental rates. The total of personal use days is 45.

If there are legitimate days when a vacation home is rented to non-family individuals at fair market rental rates, a portion of the rental-related expenses can then be deducted. The types of rental expenses that can be considered are advertising, auto and travel expense, cleaning and maintenance, commissions, insurance, legal and professional fees, management fees, repairs, depreciation, taxes, interest, and utilities. These expenses must be allocated between rental days and personal use days, and no depreciation is allowed on the personal use portion. It is critical for the homeowner to maintain accurate records of costs and receipts for all rental expenses.

Example 4: A vacation home is rented 100 days of the year, and the owner uses it for an additional 25 for a total usage of 125 days of the year. Eighty percent of the use is rental (100/125), and 20 percent is personal (25/125). Eighty percent of rental-related expenses may be used to offset rental income. If there are excess mortgage interest payments and real estate taxes that have not been used to offset rental income, the owner can take the balance of these items as deductions on his tax return (assuming the owner itemizes deductions).

Can the Vacation Homeowner Take a Tax Loss?

When rental-related expenses exceed rental income, there are rental losses. Whether the

[5] Section 280A(c)(3).

[6] Section 280A(d)(2) and (3).

owner can use those losses will depend on two factors. First, consider the number of personal use days versus rental days, and second, examine the active involvement of the homeowner in rental activities.[7]

If a vacation homeowner uses their vacation home for a period that exceeds the greater of 14 days or 10 percent of the rental days, the owner can use expenses to offset rental income and carry forward any excess deductions to offset future rental income. The owner must use those expenses to offset income in the following order: interest and taxes; operating costs; and, finally, depreciation.

If the owner uses the vacation home for fewer days, the expenses allocated to the rental activity may offset rental income in the year incurred, and any excess losses will be characterized as passive losses, which may not offset other active income, like wages or other business income.

Example 5: The taxpayer rents out their vacation home for 75 days and uses it personally for 25 days, a total of 100 days, so that 25 percent of the use is personal and 75 percent of the use is rental.

Total rent	$10,000
Total expenses	
Interest and taxes	$5,000
Operating costs	$6,950
Depreciation	$3,850
Total	$15,800

Because 75 percent of the total usage is rented to others, 75 percent of the total expense can offset rental income causing a rental loss of $1,850.[8] Because the owner's personal use of 25 days exceeds the greater of 14 days and 10 percent of rental days (7.5 days), the rental loss is disallowed. The owner can offset $11,850 of rental expenses against rental income and carry over the balance to future years. The expenses can first be applied to offset 75 percent of interest and taxes, then 75 percent of operating costs, and then 75 percent of depreciation. The balance is carried forward.[9]

There is an exception to that rule. If an owner actively participates in renting their vacation home, it is possible that they can deduct losses of up to $25,000 in a tax year against non-passive income, like wages. Active participation means that an owner actually spends significant time managing the rental business by locating tenants, advertising, collecting rents, deciding on terms of rental, and approving capital expenditures. The IRS will allow an owner, as an active participant in the business of renting, to offset losses with other income phased in so that once adjusted gross income is $150,000, the special allowance is reduced to zero.[10] Active participation must occur in the year of the loss or any carryover year in which losses are taken.[11]

Turning the Vacation Home Into a Business

The subject of active involvement in vacation home rentals also raises the question whether the rental activity is actually a business with a profit motive and whether the recognition of gains and losses are covered by section 162 rather than section 280A. The question is whether the rental activity amounts to a true commercial business enterprise. Any real estate rental activity is automatically treated as a passive activity unless the taxpayer is a qualified real estate professional, in which case the renting of a second home may be transformed into an active business, provided the owner is actively engaged in the management of real estate. The qualified real estate professional must demonstrate that (1) more than half of their personal services performed during that year were in real property trades or businesses in which the taxpayer materially participated, and (2) they performed more than

[7] Section 280A.

[8] $15,800 * 75 percent = $11,850. Minus rental income of $10,000 for a rental loss of $1,850.

[9] IRS Publication 527, "Residential Rental Property (Including Rental of Vacation Homes)," at 21, Worksheet 5-1 (Feb. 23, 2018).

[10] Reg. section 1.469-9(j)(1); *see* example at reg. section 1.469-9(j)(2) comparing losses on passive activities with losses for qualified real estate professionals. Taxpayers must report on Schedule E of Form 1040 and in most instances file Form 8582, "Passive Activity Loss Limitations," to claim the deduction. *See* instructions to Form 8582.

[11] Section 469(i)(1).

750 hours of service during that year in real property trades or businesses in which they materially participated.[12] For there to be material participation, an owner must show regular, continuous, and substantial involvement in the activity that is obviously a facts and circumstances test.[13] Significant management involvement may be evidence of materiality, as are other activities such as the hiring and supervising of employees or the number of hours devoted. These qualities are quite similar to the guidelines ultimately developed by the IRS for determining whether an owner of a rental property could take advantage of a section 199A deduction on a property that they operate as a rental enterprise.

In comparison, an individual might just be an investor in property, for which income and losses are passive for tax purposes. Again, this requires a facts and circumstances analysis to see whether one's activities are merely in the nature of an investor rather than an active real estate manager. For example, IRS regulations tell us that an individual is merely an investor, passively involved in real estate ownership by engaging in the following activities:

- studying and reviewing financial statements or activity reports;
- preparing or compiling financial analysis for personal use; and
- monitoring finances and operations in a non-managerial capacity or approving the decisions of a paid operator.[14]

To be in the business of renting real estate, in addition to all the activities that must be evident, the property owner must also demonstrate that he or she is actively engaged in the management of commercial property on a day-to-day basis with the primary purpose of income or profit.[15] Most vacation homes are not managed or owned this way. Most vacation home lessors are hoping to break even and merely cover the expenses of ownership.

Adding Personal Services Can Make It a B&B

The ownership of a second home might become a trade or business if, for example, that vacation home is turned into a bed-and-breakfast for which substantial personal services are rendered for the convenience of paying guests. Owners of a bed-and-breakfast would then be subject to self-employment tax with the reporting of rental income on Schedule C of Form 1040, rather than Schedule E.

Section 199A

Vacation homeowners may take advantage of the 20 percent qualified business deduction under section 199A,[16] provided they either meet the safe harbor rules under Rev. Proc. 2019-38, 2019-42 IRB 942, or demonstrate that they are actively engaged in the business of renting real estate as defined under section 162.[17] There needs to be a real demonstration of a profit-motivated business to qualify for section 199A purposes. The IRS has been seeking guidance for what activities might qualify as a rental real estate trade or business for section 199A purposes. Rev. Proc. 2019-38 offers some guidelines about what sum of activities meet that definition. These activities include:

1. advertising to rent or lease the real estate;
2. negotiating and executing leases;
3. verifying information in prospective tenant applications;
4. collection of rent;
5. daily operation, maintenance, and repair of the property, including the purchase of materials and supplies;
6. management of the real estate; and
7. supervision of employees and independent contractors.

Some activities do not demonstrate active rental real estate efforts, including financial or investment management activities, arranging financing, review of financial statements, purchasing property, or travel to and from the property.

More often, the primary reason for owning a vacation home is to vacation there, rather than to

[12] Section 469(c)(7)(B).

[13] Section 469(h)(1).

[14] Reg. section 1.469-5T(f)(2)(ii)(B) (1), (2), and (3).

[15] Reg. section 1.469-5T(f)(2)(ii).

[16] *See also* reg. section 1.199A-1 through -6.

[17] Reg. section 1.199A-1(b)(14).

make a business of rentals and generate qualified business income.

The Unique Tax Status of a Vacation Home

Other tax benefits that apply to a principal residence won't apply to a vacation home. For example, subject to limitations, the gain on the sale of a principal residence can be excluded from tax under section 121. Not so for a vacation home. To minimize tax on the sale of a vacation home, it is important to keep accurate books and records of capital improvements that might increase basis and reduce taxable gain. Capital improvements would not include the ordinary costs of repair and upkeep but would instead cover long-term permanent improvements.

Net Investment Income Tax

A vacation home is treated like an investment property and, like other investment properties, the income from rentals and the income from a sale is taken into account for purposes of the 3.8 percent net investment income tax (known as the Medicare contribution tax or NIIT[18]). Excluded are real estate professionals who devote substantial time and effort to the business of real estate making their activities active rather than passive.[19] There is a safe harbor exception found in the regulations for defining active participation for NIIT purposes. The safe harbor exists for a person who (1) participates in a rental real estate activity for more than 500 hours during the year, or (2) has participated in the real estate activities for more than 500 hours in any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year. If the taxpayer meets these safe harbor requirements, the income from the rental property is considered derived in the ordinary course of business, and the NIIT does not apply.[20] Failure to meet the safe harbor is not fatal. It may be possible to establish an active trade or business under section 1411 without meeting this test but under other facts and circumstances.[21]

[18]Section 1411.

[19]Section 469(c)(7)(B).

[20]Reg. section 1.1411-4(g)(7)(i).

[21]Reg. section 1.1411-4(g)(7)(iii).

Conclusion

Owning a vacation home has complex tax implications that cannot be ignored. As any vacation homeowner will attest, the decision to buy a vacation home can be a dream come true or a nightmare. Friends and relatives stop by, stay over, and share the dream. Water pipes break in the winter and go undetected for weeks, causing all sorts of major damage. Hurricanes wash away the beach, and dunes are built, blocking the view. If you or someone you know are still drawn to owning a vacation home where you can decorate thematically, store a change of clothes, and cook large meals for friends and family, then plunge ahead, but be cautious of the tax complexities and the effect on your next tax return. ■