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Recent low mortgage interest rates have enabled more people to own vacation homes (including boats with sleeping accommodations). Vacation homes can reduce income taxes under certain circumstances.

General Rules for Deductions

Vacation homes fall into one of three categories of rules.

Nominal rental rules. If the rental period is less than 15 days, ignore rental income and rental expenses for tax purposes. All property taxes and mortgage interest are generally deductible in full but other expenses are probably not deductible.

Residence rental rules. If the rental period is longer than 14 days, either the residence rental rules or the rental property rules apply. Residence rental rules apply if personal use is greater than 14 days and also greater than 10 percent of rental days.

For example, if the taxpayer uses the residence as a vacation home for 20 days and rents the residence to others for 190 days, residence rental rules apply. The 14-day test is met (20 days are more than 14) and the 10 percent test is met (20 days are greater than 19 days or 10 percent of 190 days). Consequently, rental property expenses are deductible up to the amount of rental income.

Losses cannot reduce income tax. If expenses exceed income, the excess can be used in a future tax year but only to the extent that future rental income exceeds future rental expenses.

Rental property rules. If the rental period is longer than 14 days and residence rental rules do not apply, rental property rules go into effect. For example, suppose that the rental period from the previous example was 210 days instead of 190 days. Rental property rules would apply because the 10 percent test is not met (20 personal days are less than 21 days, or 10 percent of 210 rental days).

The significance is that the rental property rules enable the taxpayer to deduct losses if rental expenses exceed rental income, but only if certain other conditions are met. These other conditions pertain to the passive activity loss (PAL) limitation rules and the at-risk limitation rules. Both sets of rules can delay or eliminate loss deductions in certain situations depending on the taxpayer's level of active involvement with the property and the manner in which the property is financed. The elimination of the loss deductions may cause taxpayers to prefer the residence rental rules rather than the rental property rules. However, if taxpayers can meet these hurdles and their income is not over $150,000, they may be able to deduct up to $25,000 of passive losses.

New Tax-Planning Perspectives

Choice of allocation method. In the previous examples, the actual number of rental days is the denominator according to IRS rules. For instance, the denominator in the first example is 190 days. This results in the 10 percent test being met, which requires residence rules to be used. However, two appellate courts have given taxpayers the choice of using 365 days as the denominator, thereby giving taxpayers a better chance of failing the 10 percent test, allowing them to use the rental property rules. The full-year denominator in the first example results in a personal-use percentage of only 5.5 percent (20 days divided by 365 days).

Increasing the interest deduction. As noted, if the rental property rules apply, the PAL, at-risk rules or both may limit deductions, such as the mortgage interest deduction. The amount of interest that is deductible can be increased if the taxpayer can borrow on a line of credit secured by the principal residence ("home equity indebtedness"). Interest on up to $100,000 of home equity indebtedness is generally fully deductible regardless of how the borrowed funds are used.

The rules and tax planning strategies for a vacation home are complex if the home is rented for any part of the year. Thus, vacation homeowners are always advised to consult with a tax accountant or tax attorney to maximize the tax benefits from vacation home rentals.

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