REAL ESTATE CENTER
TEXAS A&M UNIVERSITY

Vacation Home Rentals: Recent Tax Developments

Dr. Jerrold J. Stern
February 11, 2015
Publication 2089

Recent stock market gains and low mortgage interest rates are enabling more individuals to purchase vacation homes. In addition to offering personal enjoyment, vacation homes can be rented out to help offset expenses and reduce the owners' taxes.

But beware. A 2014 tax court case highlights how poor record-keeping and the manner in which days are spent in connection with repairing a vacation rental home may eliminate eligibility to deduct losses. Furthermore, a new 3.8 percent surtax on unearned income (introduced in 2013) could produce a higher tax cost when selling income-producing real estate, including vacation rental homes. The court case and surtax are discussed here, following a summary of key vacation rental home rules

The Takeaway

Vacation home rentals can decrease income taxes under certain circumstances. However, a 2014 court case demonstrates how the personal use of a rental vacation home can decrease tax benefits. A new 3.8 percent surtax on unearned income may increase taxes when vacation rental homes are sold.

Typical expenses associated with vacation rental homes include mortgage interest and real estate taxes, which are deductible under any circumstances. In addition, if the property is rented more than 14 days, a proportionate amount of expenses such as rental management company fees, utilities, maintenance and tax depreciation may also be deductible. The latter expenses can generate a tax loss (deductible against nonrental income) if the number of personal-use days does not exceed the greater of 14 days or 10 percent of the number of rental days.

The taxpayer must maintain careful records, such as a logbook of how time was spent while at the property along with receipts for all expenses. A 2014 tax case focuses on how to assess whether days are considered personal use. If the property is rented for 14 days or less, the rental income and related expenses are ignored for tax purposes

Assume the taxpayer uses the residence as a vacation home for 16 days and rents to others for 100 days. Both the 14-day personal-use test is met (16 days are greater than 14), and the 10 percent test is met (16 days are greater than 10 percent of 100 days, or 10 days). Consequently, rental property expenses are still deductible but only up to the amount of rental income. If expenses exceed rental income, the resulting net loss can be deducted in a future tax year but only to the extent that future rental income exceeds future rental expenses. However, if the rental period is 170 days (10 percent of which equals 17 days), then all expenses allocable to the rental period are deductible and they are allowed to generate a deductible tax loss that can reduce taxes on nonrental income

A 2014 court case illustrates that the IRS assesses personal-use days very carefully when days are spent repairing or maintaining the property. In the case, the concern was whether tax losses could reduce nonrental income. The taxpayer spent 24 days in connection with making repairs and performing maintenance on the vacation home and classified the days as nonpersonal (and nonrental).

However, even though the taxpayer endeavored to maintain adequate records, the IRS and the court counted some of the 24 days as personal because they contained a combination of personal use (that is, relaxation) and repairs. Also, some of the taxpayer's records were suspect. As a result, the number of personal days identified by the court was sufficient to preclude the deduction of tax losses against nonrental income.

Separate from the court case is the issue of taxation of the gain from a subsequent sale of the property. If the taxpayer sells the property at a gain, the larger of the gain or total tax depreciation deducted during the holding period is taxable. In 2013, the tax rate on the taxable gain (and other investment income) was increased by 3.8 percentage points for high-income taxpayers — generally, marrieds filing jointly with adjusted gross income (AGI) more than $250,000 — and singles with more than $200,000 AGI.

The rules and tax-planning strategies for a vacation home are complex if the home is rented. Vacation homeowners are advised to consult with a tax accountant or tax attorney to maximize the tax benefits from vacation home rentals.

Dr. Stern (stern@indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.

© 2015. Real Estate Center. All rights reserved.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

DIRECTOR

GARY W. MALER

ADVISORY COMMITTEE

C. CLARK WELDER, CHAIRMAN
San Antonio

RUSSELL CAIN, VICE CHAIRMAN
Port Lavaca

MARIO A. ARRIAGA
Conroe

DOUG ROBERTS
Austin

JACQUELYN K. HAWKINS
Austin

KIMBERLY SHAMBLEY
Dallas

DOUG JENNINGS
Fort Worth

RONALD C. WAKEFIELD
San Antonio

TED NELSON
Houston

BILL JONES, EX-OFFICIO
Temple