Tax Ramifications of Owning a Second Home

Many taxpayers own or plan to purchase a second home. If you are among these taxpayers, you may be viewing your second home either for personal pleasure or as an investment for tax benefits and appreciation. Perhaps you are somewhere in between. But, regardless of how you view your second home, planning for its tax implications will enable you to either own the property in the most tax-efficient way possible or, if your purchase is somewhat tax driven, maximize the allowable deductions the property generates. A second home can fall into one of three categories for tax purposes, depending on how it is used: personal residence, vacation home, or rental property.

A property used for personal purposes more than 14 days during the year, or more than 10% of the rental days if that number is greater, is considered to be a residence. If this residence is rented for fewer than 15 days during the calendar year, it is considered to be a *personal* residence. As such, the downside is you are not entitled to deduct any rental expenses, but on the plus side, rental income received is not taxable. However, interest expense (to the extent it is qualified residential interest) and real estate taxes are fully deductible subject to the overall limitation on itemized deductions.

If the property is used as a residence (see above) and is rented more than 14 days during the calendar year, it is considered to be a vacation home, and the reporting of income and deductions is subject to limitations. In this situation, interest, taxes, and casualty losses are normally fully deductible. Other property-related expenses are deductible to the extent of rents received, but only after first considering the interest, taxes, and casualty losses previously mentioned.

Where personal use does not exceed 14 days (or 10% of rental days, if greater) and the property is rented for at least 15 days, the second home is considered to be rental property. For second homes classified as rental property, interest, taxes, casualty losses, and other operating expenses are fully deductible. However, these expenses must be prorated for any period of personal use. In addition, the property is subject to the passive activity loss rules and at-risk limitations, meaning net losses may have to be deferred to a future tax year and not currently recognized.

If all this sounds technical and confusing, it is. But, the proper treatment of second homes is extremely important at tax time. So, please contact us if you have questions on how to handle income and expenses related to your second home.