Tax Issues When Your Vacation Home Is a Rental Property

If you have a home that you both rent out and use personally, you have a tax-code-defined vacation home.

Under the tax code rules, that vacation home is either

- a personal residence, or
- a rental property.

Personal Residence

The tax code classifies your vacation home as a personal residence if

- you rent it out for more than 14 days during the year, and
- your personal use during the year *exceeds the greater of* (a) 14 days or (b) 10 percent of the days you rent the home out at fair market rates.

Count only actual days of rental and personal occupancy.

Disregard days of vacancy, and disregard days that you spend mainly on repair and maintenance activities. "Personal use" generally means use by the owner (that would be you), certain family members, and any other party (family or otherwise) who pays less than fair market rental rates.

If your vacation home is used by another person under a reciprocal arrangement (e.g., "I use your place and you use mine"), such use is considered personal use. That is the case whether or not you charge the other person fair market rent for the use of your property and whether or not you pay fair market rent for your use of the other person's property.

Rental Property

The tax code classifies your vacation home as a rental property if

- you rent it out for more than 14 days during the year, and
- your personal use during the year *does not exceed* the greater of (a) 14 days or (b) 10 percent of the days you rent the home out at fair market rates.

Once again, count only actual days of rental and personal use.

Disregard days of vacancy, and disregard days that you spend mainly on repair and maintenance activities.

Example 1. Vacation home classified as rental property

This year, you will rent your beachfront condo to third parties at fair market rates for 240 days. You and family members will use the condo for 22 days. Since personal use does not exceed the greater of (a) 14 days or (b) 10 percent of the rental days (24 days), your condo is classified as a rental property for the 2022 tax year.

Variation. If you and/or family members use the condo for 25 days or more during the year, the tax code classifies the property as a residence and levies special rules on the rental income and expenses.

Fundamental Tax Rules for Rental Properties

For vacation homes that are classified as rental properties, you must allocate mortgage interest, property taxes, and other expenses between rental and personal use, based on actual days of rental and personal occupancy.

Mortgage Interest Deductions

Mortgage interest allocable to personal use of a rental property does not meet the definition of qualified residence interest for itemized deduction purposes. The qualified residence interest deduction is allowed only for mortgages on properties that are classified as personal residences.

Example 2. Impact of classification as rental property on mortgage interest deductions

As in Example 1, you will rent your beachfront condo for 240 days this year and use it for personal purposes for 22 days. The tax code treats your condo as a rental property.

That means you must allocate all the expenses between rental and personal use, using 240/262 as the rental-use fraction and 22/262 as the personal-use fraction. Accordingly, 22/262 of the mortgage interest for the condo is non-deductible. The same is true for 22/262 of the other expenses (insurance, utilities, maintenance, depreciation, etc.).

You can deduct the personal-use portion of real property taxes on Schedule A of Form 1040, subject to the limitation on itemized deductions for state and local taxes: $10,000 (or $5,000 if you use married filing separate status).

Schedule E Losses and the PAL Rules

When allocable rental expenses exceed rental income, a vacation home classified as a rental property can potentially generate a deductible tax loss that you can claim on Schedule E of your Form 1040.

Great!

Unfortunately, your vacation home rental loss may be wholly or partially deferred under the dreaded passive activity loss (PAL) rules. Here’s why.

You can generally deduct passive losses only to the extent that you have passive income from other sources (such as rental properties that produce positive taxable income).

Disallowed passive losses from a property are carried forward to future tax years and can be deducted when you have sufficient passive income or when you sell the loss-producing property.

“Small Landlord” Exception to PAL Rules

A favorable exception to the PAL rules currently allows you to deduct up to $25,000 of annual passive rental real estate losses if you “actively participate” and have adjusted gross income (AGI) under $100,000. The $25,000 exception is phased out between AGI of $100,000 and $150,000.

The Seven-Days-or-Less and Less-Than-30-Days Rules

The IRS says the $25,000 small landlord exception is not allowed

- when the average rental period for your property is seven days or less, or
- when the average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers.

Key point. If your rentals average less than 30 days per renter, you are renting to transients, and that can trigger other rules.

“Real Estate Professional” Exception to PAL Rules

Another exception to the PAL rules currently allows qualifying individuals to deduct rental real estate losses even though they have little or no passive income. To be eligible for this exception,

1. you must spend more than 750 hours during the year delivering personal services in real estate activities in which you materially participate, and
2. those hours must be more than half the time you spend delivering personal services (in other words, working) during the year. If you can clear those hurdles, you qualify as a real estate professional.

The second step is determining whether you have one or more rental real estate properties in which you materially participate. If you do, those properties are treated as non-passive and are therefore exempt from the PAL rules. That means you can generally deduct losses from those properties in the current year.

Meeting the Material Participation Standard

The three most likely ways to meet the material participation standard for a vacation home rental activity are when the following occur:

- You do substantially all the work related to the property.
- You spend more than 100 hours dealing with the property, and no other person spends more time on this property than you.
- You spend more than 500 hours dealing with the property.

In attempting to clear one of these hurdles, you can combine your time with your spouse's time. But if you use a management company to handle your vacation home rental activity, you're very unlikely to pass any of the material participation tests.

Example 3. Meeting the material participation standard

You can't take advantage of the $25,000 passive-loss exception for rental real estate because your AGI is too high. You have zero passive income, and you don't qualify as a real estate professional. As a result, you have been piling up suspended passive losses from your vacation home rental activity.

But you may be able to transform the activity into a "non-rental" using either the seven-days-or-less or the less-than-30-days rule. Then, as long as you can pass one of the aforementioned material participation tests for the property, you can completely avoid the PAL rules and deduct the vacation home rental losses against your other income on Schedule C.

Planning Rental-Use and Personal-Use Days for the Rest of the Year

The COVID-19 pandemic appears to be winding down. Finally!

Your post-pandemic use pattern may differ from the earlier norm.

For instance, you and family members may be anxious to spend more time away from the crowds at the vacation home and less time in the big city. That could put the property firmly into the personal residence category. If so, adding more personal-use days may increase your itemized deductions for qualified residence interest expense and property taxes.

But if you're affected by the limitations on deductible interest and taxes, adding more personal-use days may just result in bigger personal-use allocations of interest and taxes that you can't write off as itemized deductions because of the limitations. You must run the numbers to find out.

Or the rental demand for your vacation home may be so high that you can't afford to ignore the opportunity to collect more rental income. That could put your vacation place firmly into the rental property category, with tax results as explained in this article.

In this scenario, adding more rental days can often lead to better financial results, because you can usually shelter the additional rental income with allocable rental expenses. More tax-free rental income is always a good thing!

If the average rental period for your property meets the seven-days-or-less and the less-than-30-days tests, and you can meet the material participation standard, and you have an overall loss, then currently you can deduct that loss—thanks to the exceptions to the passive-loss rules.

Takeaways

If you have a home that you both rent out and use personally, you have a tax-code-defined vacation home.

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- a rental property.

The tax code classifies your vacation home as a rental property if

- you rent it out for more than 14 days during the year, and
- your personal use during the year *does not exceed* the greater of (a) 14 days or (b) 10 percent of the days you rent the home out at fair market rates.

You count only actual days of rental and personal use.

You disregard days of vacancy, and disregard days that you spend mainly on repair and maintenance activities.

In this article, we covered the tax rules for vacation homes that are classified as rental properties. When so classified, the vacation home runs the standard rental property gauntlets such as the PAL rules—all of which are explained in the article.

You may be able to micro-manage the number of rental and personal-use days between now and the end of the year. That use pattern can potentially result in better or worse tax outcomes for this year, especially if it flips your vacation home from personal residence status to rental property status or vice versa.