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The Tax Rules for Renting Out Your Vacation Home

By LAURA SAUNDERS

Summer is here, and so is this year's crop of summer rentals. In some areas, the market for vacation properties is even perking up after a string of down years.

If you are a vacation-home landlord or thinking of becoming one, it is time to review the tax rules on rental income from second homes.

Getty Images

Vacation homes at the Port of the Islands development in Naples, Fla.

This isn't beach reading. Apart from one simple provision, this area is among the messiest in the tax code—"worse than luxury-car depreciation and almost as bad as the alternative minimum tax," says CPA Douglas Stives of Monmouth University in New Jersey.

First, the good news: One of the tax code's best freebies allows homeowners who rent out their property for 14 or fewer days a year to pocket the rental income, tax-free. Often called the "Masters exemption" because it is used by homeowners near the Augusta National Golf Club, who earn as much as $20,000 during the annual tournament, this provision also is popular with people living near Super Bowl sites or national political conventions.

It's available to anyone renting out a home, and the income doesn't have to be reported on the owner's tax return as long the rental period is 14 or fewer days. The taxpayer can't take depreciation or maintenance deductions, but can deduct mortgage interest and property taxes on Schedule A.

This generous break can be taken only once a year, experts say, and it can't be taken at all if the home is rented for longer than 14 days.

Things get much more complicated if a home is "mixed-use"—meaning the owner uses it himself and rents it out. In that case he has to count the rental days and determine what percentage they are of the total number of days the property was used. That gives the percentage of expenses such as maintenance, utilities, property taxes, mortgage interest and depreciation that are deductible from the rental income.

Previously

Here's a simple example: A homeowner has a beach house that

"Vacation Homes Beckon," (5/5/12)

is rented from June through August, and the owner's family uses it the last week of May and the first two weeks of September. Otherwise the house is closed.

So there are 113 total days of use, of which 92 are rental days. That means 81% of the expenses listed above can be written off against the rental income on the owner's Schedule E, according to Abe Schneier, a tax specialist at the American Institute of CPAs. The other 19% of the expenses aren't deductible, except the mortgage interest and property taxes, which appear on the owner's Schedule A.

Details matter. Days used by the owner to repair and maintain the property don't count anywhere in the tally, but taxpayers should be sure to document them carefully, because the Internal Revenue Service is suspicious about these deductions. The gold standard of proof is "contemporaneous records" such as time-stamped store receipts or a log.

"It wouldn't hurt to take pictures," Monmouth's Mr. Stives says.

Other caveats: The IRS may try to count days used by immediate family members as "personal days," even if relatives pay a market rent. Depreciation doesn't apply to land, only to structures, but it does extend to furniture and appliances. Whatever you do, don't exchange checks of the same amount with friends or relatives to create fictitious rental income.

What if, after all your figuring, the Schedule E shows a loss? The complications continue. If a taxpayer's personal use is more than 10% of the total days rented, then the losses aren't deductible, except for property taxes and mortgage interest.

If the personal use is less than 10% of the days rented, however, then joint filers with $100,000 or less of adjusted gross income can deduct up to $25,000 of losses against their ordinary income—a nice benefit. The deduction phases out for incomes above that and disappears at $150,000. But the unused losses carry forward and can be deducted in the future.

The bottom line: If you want to be a summer-rental landlord, either keep it simple or keep good records.

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