REPORTING RENTAL INCOME & EXPENSES *of a* SECOND *or* VACATION HOME

Background:

Rental income on a second or vacation home may be offset by deductions incurred in connection with the property. However, if these expenses exceed rental income, the resulting loss is subject to deduction limitations. The law also prevents most homeowners from deducting losses on the rental of a personal vacation home or personal residence if the owner or close relative personally use the premises for more than 14 days during the year (or, if greater, 10% of the days on which the house was rented to others). Tests based on the number of days of personal and rental use determine whether the house is treated as a "residence" or as "rental property". If the house is deemed to be a residence, your deductions are generally limited to interest and real estate taxes. If treated as rental property you may deduct other expenses and deduct a loss, if any, subject to passive activity rules.

Under these passive activity rules you generally may not deduct rental losses from other income such as salary, interest and dividends. Rental losses may offset only other rental and passive activity income. When you rent out your home for part of the year and also use it personally on some days during the year, expenses are allocated between personal use and rental use days.

Renting to a Relative:

The number of days of personal and rental use determines how you must report income and expenses of a residential unit in which you live part of the year and rent or offer for rent for the days you do not live there. The law distinguishes between a rental of home by a close relative as a principal residence and a rental that is not the relative's principal residence, such as a second home or vacation home. On a fair market rental of a home to a close relative used as a ***principal residence***, your relative's use is not considered personal use by you that could bar a loss under the number of days personal-use test. A relative's use of the home as a ***vacation home*** is attributable to you in applying the personal use test even if you receive a fair market value rent.

Rental of Less than 15 Days During the Year:

If you rent the house for fewer than 15 days in the taxable year, you do not report the rental income on your return, and the only deductions allowed are those you would be allowed as a homeowner. That is, you can deduct only mortgage interest and real estate taxes, (or casualty losses, if any). No other rental expenses such as depreciation and maintenance expenses are deductible. Interest is generally fully deductible provided the debt is secured by the same home, and the total debt does not exceed $1,000,000. In counting days of personal use, use by close relatives generally qualifies as your personal use. For example, if you use the house for ten days and your brother's family uses it ten days, you are considered to have used it for more than 15 days during the year.

Rental of 15 Days or More During the Year:

A daily-use test determines whether your use of the house during the year is treated as residential use that requires you to limit your deductions to the amount of rental income. You are considered to have used the house as a residence if your personal-use days (and use by close relatives) exceed 14 days during the year. When treated as a residence, rental expenses are deductible only to the extent of rental income. Expenses not deductible in the current year under this limitation may be carried forward and

will be deductible up to rental income in the following year. The deduction limit is irrelevant if your rental income exceeds expenses.

If your personal use days do not exceed 14 days, your rental deductions are not limited by the personal-use test. In other words, you may treat the house as a rental property and deduct other expenses such as depreciation and maintenance to create a loss. However, a loss deduction is subject to the passive activity loss restrictions. Such losses are only deductible against income from other passive activities. Losses disallowed by the passive activity rules are suspended and carried forward to later taxable years and become deductible only when passive income is earned.

Example:

In 2003 you rented out a vacation house in Florida at fair market rental for 140 days. If you or a close relative personally used the house for more than 14 days, the house is considered a residence and generally limits the deductions to interest and real estate taxes. If you use the house for 14 days or less, you may treat the house as rental property and you may deduct a loss, if any, subject to the passive activity rules discussed above.

Checklist of Rental Deductions:

The following expenses may be deductible from rental income on property classified as rental property:

- ✓ ***Real Estate Taxes***
- ✓ ***Mortgage interest***
- ✓ ***Depreciation*** – You may deduct depreciation on the cost basis of the building based on a 27-½ year recovery period. Furniture, carpeting, and appliances are considered five-year property for depreciation purposes.
- ✓ ***Management expenses*** – such as fees paid to a company for collecting rents or managing the property
- ✓ ***Utilities*** – such as heating, repairs, lighting, water, electricity, gas, and telephone
- ✓ ***Salaries and wages*** paid to superintendents, janitors, and service and maintenance personnel.
- ✓ ***Travel expenses*** to look after the property. If you travel away from home to inspect or repair rental property, be prepared to show that the trip was the primary purpose of the trip, rather than vacationing or other personal use. Otherwise, the IRS may disallow deductions for travel costs.
- ✓ ***Legal expenses*** for dispossessing tenants.
- ✓ ***Insurance premiums*** for fire and liability coverage. If payment is made in one year for insurance covering a period longer than one year, you must amortize and deduct the premium over the life of the policy.
- ✓ ***Tax return preparation*** – You may deduct as a rental expense the part of the tax preparation fee allocable to preparation of Schedule E to report rental income and expenses.
- ✓ ***Repair and maintenance expenses*** – Only maintenance and incidental repair costs are deductible against rental income. Improvements that add to the value or prolong the life of the property are capital improvements. Capital improvements are not deductible in the year paid but may be depreciated over their useful life. Repairs include painting, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows. Adding a room, putting up a fence, replacing the plumbing or wiring, putting on a new roof, and paving a driveway are examples of capital improvements.