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Dear Clients and Colleagues:

This summer's weather is a mix of hot and cold temperatures, and the rain we need so desperately is coming now in sprinkles along with thunder and lightning. Along with changes in the weather patterns, I am changing the style of my regular client letters. Instead of highlighting numerous recent cases and issues, I will feature tax and estate planning topics in greater depth. I hope that my article published in the Contra Costa Lawyer Magazine, "*You've Got (IRS) Mail! What Happens When Your Tax Return is Chosen for Audit*," mailed to you in the spring was informative. Let me know if there are any particular topics you would like me to cover in future letters.

On July 9th, I provided an expert presentation to the Council of Business Advisors, East Bay group, entitled, "IRS Collections: Options for Unpaid Tax Liabilities." I discussed various alternatives available to taxpayers who find themselves in the uncomfortable position of owing money to the IRS or the Franchise Tax Board.

Topic: Vacation Home Rentals and Sales

An improved economy, a strengthened real estate market in many areas, and a favorable interest rate environment has renewed interest in vacation or second homes. These homes offer a chance to provide the family with a place to relax at a reduced cost when compared to expensive short-term resort rentals, and at the same time they give owners the possibility of capital appreciation over the long term. They also offer owners a chance to earn some rental income when they or family members are not using the property. Taxation of these rental arrangements can be tricky.

Tax Treatment of Vacation Home Rental

The tax treatment of renting out a vacation home depends on the mix of personal and rental use. If personal use of the home is extensive enough for it to be considered a personal residence under the tax code, then (a) deductions for the rental portion will be restricted by the vacation home rules, but (b) deductions for the personal use portion will not be affected. If the rental use is sufficient for the property to be treated as rental property, not as a personal residence, then (a) the owner's rent-related deductions will be restricted by the passive activity loss rules, not the vacation home rules, and (b) deductions for the personal use portion will be adversely affected.

Vacation Home Used as a Personal Residence

A vacation home is treated as used as a personal residence during a tax year if personal use exceeds the greater of 14 days or 10% of the days the property is rented to others during the year at a fair market rental. Although the property is considered to be a residence, the owner still must treat the rental portion of the vacation home separately from the personal portion.

Rental portion. With an exception for limited rental use noted below, rentals are included in income on Schedule E, but may be offset with deductions for the rent-related portions of expenses such as utilities, maintenance, upkeep, mortgage interest, real estate taxes and insurance. The owner also may claim a depreciation deduction relating to the rental use. However, rent-related deductions can't exceed rental income less:

1. Other deductions related to the rental activity itself, such as advertising, broker's commissions, cleaning fees paid by the owner after rental periods, and possibly the owner's costs to travel to the vacation home specifically in connection with its rental use, such as interviewing tenants or arranging for cleaning or repairs.
2. Deductions (such as interest and real estate taxes) allocable to the rental use which would be deductible whether or not the vacation home was rented.

Excess expenses are carried forward and may be used in a future year when there is additional rental income. For a year in which the personal residence rules apply to a property, the passive loss rules do not apply.

Personal portion. The owner deducts on Schedule A real estate taxes and mortgage interest allocable to personal use of the home. Because personal use exceeds the greater of 14 days or 10% of the days it is rented out during the year, the vacation home is treated as a qualified residence for purposes of the mortgage interest deduction. If the taxpayer does not own another vacation home and meets the other rules for deducting qualified residence interest, the personal-use portion of the year's mortgage interest can be fully deducted.

Allocating expenses. IRS says that *all* expenses are apportioned between rental and personal use based on the number of days used for each purpose. However, the Tax Court and two Courts of Appeal have held that interest and taxes are allocated to rental use based on the ratio of actual rental days to total calendar days. All other expenses (e.g., utilities and maintenance) are allocated based on the ratio of rental days to total days of use. The Courts' approach can yield bigger overall deductions for the vacation home owner.

> ***Example:*** a home is rented three months a year and used by the owner for vacations for one month a year. IRS would allocate interest and taxes based on the period of actual occupancy (four months), and the amount of rental income against which other expenses can be deducted is reduced by 3/4ths of the interest and taxes. The Courts permit interest and taxes to be allocated on the basis of an

entire year, so rental income would be reduced by only 1/4th of the interest and taxes, and the other 3/4ths could be offset by expenses related to the rental. The reduction in the rental expense to only 1/4th of the total can allow a larger deduction of other rental expenses.

Special rule for limited rental use. A taxpayer who rents out his vacation home for fewer than 15 days during the year is not required to report rental income and cannot claim offsetting rent-related deductions. This one-of-a-kind tax break can be a windfall for those who own properties in prime vacation spots or in other sought-after areas (e.g., one near a prime sporting event) where even a few rental days can bring in substantial dollars.

Vacation Home Used as Rental Property

A vacation home is treated primarily as rental property for a tax year in which personal use of the unit does not exceed the greater of 14 days or 10% of the days the property is rented out during the year at a fair rental amount. In this situation, the owner's deductions are restricted by the passive loss rules, not by the vacation home rules.

Rental portion. When a vacation home is treated as rental property, its income and deductions generally are treated as passive in nature (unless the owner qualifies under the material participation standard for qualifying real estate professionals). If deductions allocable to the rental portion exceed rental income, the loss generally can only offset other passive income until the property is disposed of. However, if the owner actively participates in the vacation home rental activity, and adjusted gross income (AGI) doesn't exceed $100,000, then non-passive income can be sheltered with up to $25,000 of losses from active-participation real estate rental activities, including the vacation home rental enterprise. The $25,000 allowance starts to phase out when AGI exceeds $100,000, and disappears completely when AGI reaches $150,000.

The active participation standard, which is less stringent than the material participation requirement, can be satisfied without regular, continuous, and substantial involvement in operations as long as the taxpayer participates in a significant way by, for example, making management decisions or arranging for others to provide services. Management decisions that are relevant in determining whether a taxpayer actively participates include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. The $25,000 allowance will not be available if a management or rental agent handles all aspects of renting the unit and maintaining it.

Special rules apply where the property has only short-term rentals.

Example: If the average period of customer use is seven days or fewer, the property will be treated as a trade or business, which means the taxpayer must be a material participant in the activity in order to claim deductions in excess of income.

Personal portion. The owner gets a Schedule A itemized deduction for the real estate taxes allocable to his personal use of the vacation home. However, since personal use does not exceed the greater of 14 days or 10% of the time the unit is rented out, the home is not treated as a qualified residence. As a result, the interest paid on a mortgage secured by the vacation home, and allocable to personal use, will be treated as nondeductible personal interest.

Tax-Free Sale of Vacation Home

A taxpayer may sell the family home at retirement and move into what had been a vacation home. If the vacation home is later sold, gain on the sale of both homes is eligible for the up-to-$250,000 exclusion ($500,000 for qualifying married taxpayers) if each home is owned and used as a principal residence for at least two of the five years preceding the sale date of each home, and two years elapse between the sales. A reduced home-sale exclusion may apply to taxpayers who (1) fail to qualify for the 2-out-of-5-year ownership and use rule, or (2) previously sold another home and excluded gain within the 2-year period prior to the sale date of the current home. The reduced exclusion rule applies if the taxpayer's failure to meet either rule occurs because the home must be sold due to a change of place of employment, health, or other unforeseen circumstances.

Any part of the gain attributable to depreciation for post-May 6, 1997 periods is not eligible for the exclusion.

Reduced homesale exclusion for nonqualified use. The rule excluding home-sale gain if the 2-out-of-5-year rule is met will not apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use. Generally, nonqualified use is any period during which the property is not used as the principal residence of the taxpayer or spouse. For example, use of a residence as a vacation home or as rental property is nonqualified use.

> ***Example*:** a single taxpayer buys a residence this year, uses it as a vacation home for four years, and then uses it as a principal residence for four years. He owns no other residences. If he subsequently sells the home and realizes a gain of $500,000, half of the gain will be allocable to nonqualifying use and subject to tax as long-term capital gain (and the 3.9% surtax on unearned income), but the other half will qualify for the full $250,000 homesale exclusion.

Tax-Deferred Exchange of Vacation Home

Under Code Sec. 1031, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. Property held for productive use in a trade or business may be swapped for property held for investment, and property held for investment may be swapped for property held for productive use in a trade or business.

A personal residence cannot be exchanged tax-free under Code Sec. 1031 because it is not held for productive use in a trade or business or for investment, unless it is used only occasionally for personal purposes. The relinquished property must qualify as a rental for the two years prior to the exchange and the replacement property must qualify as a rental for the two years after the exchange. They each must be rented for fair rental value for 14 days or more, and the owner's personal use of the residence cannot exceed the greater of 14 days or 10% of the number of days each year that the residences are rented at fair rental value.

A taxpayer is treated as using a dwelling unit for personal purposes for a day if the unit is used for personal purposes by: (1) the taxpayer or any other person who has an ownership interest in the dwelling unit or by a member of the family of the taxpayer or the other owner; (2) any individual who uses the unit under a reciprocal use arrangement; or (3) by any individual unless for that day the dwelling unit is rented for a fair rental value.

The replacement property received in the Code Sec. 1031 exchange ultimately may qualify for the home sale exclusion if the requirements are met. However, there are two limitations on this approach:

1. If a vacation home is received as replacement property, any rental use of the replacement property will limit the home-sale exclusion.

2. If a home is acquired in a Code Sec. 1031 exchange in which any gain was not recognized, the principal residence exclusion will not apply to the sale of the home by the taxpayer for the 5-year period beginning with the date of acquisition.

This discussion highlights some rules that apply to the tax treatment of vacation homes. Contact me to tailor a plan that will apply these rules to benefit you as much as possible.

Very truly yours,

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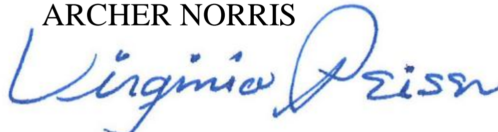

J. Virginia Peiser

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Enclosure
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