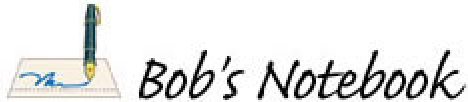

PERSONAL-USE TIME DETERMINES VACATION-HOME TAX BREAK

Realty Tax Tips: Save on loan interest, travel costs

Millions of U.S. taxpayers own secondary or vacation homes that they use part of the year. But they often fail to maximize their tax savings from their part-time residences. Keeping simple tax records for your second home can result in saving hundreds or even thousands of tax dollars.

FOUR TAX POSSIBILITIES FOR YOUR VACATION OR SECOND HOME. Depending on your personal-use time of your vacation or second home, Uncle Sam puts you into one of four possible tax categories.

If you itemize your income tax deductions, your vacation or second home mortgage interest and property taxes will always be deductible. But there can be additional tax breaks, depending on how much time you personally use the property.

1 – NO PERSONAL-USE TIME. If you didn't personally use your vacation or second home and rented or had it available for rent all of 2004 (other than for a few days while you occupied the property to make repairs), then your second home is classified as a rental property.

Rather that itemizing your mortgage interest and property taxes on Schedule A of your income tax returns, in this category you should report the rental income and expenses on Schedule E of your tax returns.

In this category, you can deduct virtually all applicable expenses, such as mortgage interest, property taxes, insurance, homeowner association fees, utilities you paid, repairs and depreciation.

In addition, in this category you can deduct reasonable travel expenses to inspect (but not occupy, except for repair work) your rental property (especially if it is in Hawaii or the U.S. Virgin Islands!).

Because your property is essentially a rental, your tax result will probably be a "tax loss" (primarily due to the non-cash depreciation deduction). But Uncle Sam considers rental property a "passive activity" even if you actively manage the property, collect the rent, and select the tenants.

If you earned below $100,000 adjusted gross income in 2004, you can deduct up to $25,000 of your annual tax loss from your rental property. Any annual tax loss exceeding $25,000 must be "suspended" for use in a future tax year or when you sell the second home at a profit.

An exception occurs, however, if you are a full-time "real estate professional," such as a real estate salesperson. Then there is no annual limit to your qualified rental property tax loss deductions from your other ordinary income, such as realty sales commissions.

However, if you didn't "materially participate" in managing your second or rental home in this category, or if you own less than a 10 percent interest in a property partnership, or if the property is in a "rental pool," then your tax loss exceeding the rental income must be suspended for future tax deduction use. Without material participation in rental decisions, any tax loss is not deductible from your other ordinary taxable income.

2 – BELOW 14 DAYS OF ANNUAL RENTAL. If you rented your second or vacation home to tenants less than 14 days in 2004, regardless of how much rent you received for those few days, that rent is 100 percent tax-free income to you and need not be reported to Uncle Sam. However, you can still deduct your mortgage interest, property taxes and any uninsured casualty loss (such as water or snow damage) expense.

For example, I own a second home condominium, which I personally used 48 days in 2004. But I rented it to tenants less than 14 days. Because I rented it less than 14 days, I need not report that rental income but all I can deduct as personal itemized deductions are the mortgage interest, property taxes and any uninsured casualty loss.

3 – ANNUAL PERSONAL USE UNDER 15 DAYS OR 10 PERCENT OF THE RENTAL DAYS. If your second or vacation home is in this very desirable category, there is no limit to your tax loss deductions against your ordinary taxable income (except for the $25,000 annual passive loss limit explained above). Rental income and deductible expenses are reported on Schedule E of your tax returns.

Suppose you rented your second home to tenants for 90 days in 2004. You personally occupied it for seven days. Because your personal use is below the 15 days and 10 percent of rental-day thresholds, you can deduct up to $25,000 of qualifying losses against your ordinary taxable income. But Internal Revenue

Code 183 says you must show a rental activity profit at least three of every five years in this category.

4 – ANNUAL PERSONAL USE EXCEEDING 14 DAYS OR 10 PERCENT OF THE RENTAL DAYS (IF RENTED OVER 14 DAYS IN 2004). This category of heavy personal use, but modest rental use, requires the rental income and expenses be reported on Schedule E of your tax returns.

But any resulting tax loss in this tax category cannot be used to offset your ordinary taxable income. However, unused losses are "suspended" for future tax deduction benefits, as explained above.

The correct order in this category for deducting secondary- or vacation-home expenses is mortgage interest, property taxes, uninsured casualty losses, operating expense, and depreciation. If the mortgage interest, property taxes, and uninsured casualty losses exceed the rental income, however, these excess deductions can be itemized on Schedule A.

CONCLUSION: Vacation or second homes usually do not provide great tax deduction benefits. However, they can save tax dollars, depending on your personal situation. More important, your secondary residence is probably appreciating in market value, resulting in future resale profits.

If you convert your second home into your principal residence for at least 24 of the 60 months before selling it, up to $250,000 of your sales profits can be tax-free (up to $500,000 for a married couple where both spouses qualify). For full details, please consult your tax adviser