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Tax Strategies for Vacation and Second Homes

An Exclusive Special Report from
BradfordTaxInstitute.com

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Create Deductions: Use Your Vacation Home for Business Lodging

Here's good news: the *properly used* business vacation home or condo does not suffer from

- the vacation-home rules,
- the passive-loss rules, or
- the entertainment-facility rules.

In these days of COVID-19, you may have solid reasons to use your vacation home or condo for two purposes only:

- personal pleasure, and
- business lodging.

In this section, you learn how limiting use to the two purposes above creates good tax results with no tax complications.

How Business Use Escapes the Dreaded Vacation-Home Rules

Do you use your business vacation home or condo *solely* for business lodging?

If so, you escape the vacation-home rules and may deduct your business-lodging costs. The law is very clear on this. The vacation-home section of the tax law, Section 280A(f)(4), states that nothing in the vacation-home rules shall disallow any business deduction for business travel.[1]

Example 1. You use your beach home for overnight business lodging 37 times during the year. You have no personal or rental use of the beach home. Your beach home is a 100 percent business asset and deductible as such.

One exception to this business-lodging rule. The law does not grant the business-lodging exception to landlords who rent dwelling units. If you have apartment buildings or other residential rentals, staying at your vacation home or condo to look after your rentals does not let you escape the unfavorable vacation-home rules.[2]

In *Andrews*, the court noted that congressional floor debates discuss homes that qualify for deductible business lodging expenses.[3] The floor debates note that members of Congress may deduct the *business portion* of their out-of-town lodging expenses while serving in the U. S. Congress.[4]

This means that members of Congress may deduct the business part of their Washington, D.C., homes because they use them for business travel.

While serving in the Senate, Senator Bob Dole stated that the vacation-home rules in tax code Section 280A(f)(4) clarify that personal use of a home does not disallow the business expenses for travel away from home.[5]

In other words, you can have a second home, such as a vacation home, that you use for both business and personal purposes—under Section 280A(f)(4), the personal use will not nullify the business use.

So here is what you have so far, assuming you do not rent the vacation home or condo for even one day:

- Business use of the property does not trigger the vacation-home rules.
- Personal use of the property does not trigger the vacation-home rules or destroy the business deductions.
- When you have both business and personal use of the condo, you must divide the condo into its business and personal components.

Example 2. Fred uses his beach home for 70 nights of business lodging and 30 nights of personal lodging. He has a 70 percent business-use beach home and a 30 percent personal-use beach home.

Planning note. Fred has his tax home where he regularly works, in New Jersey. He travels to his South Carolina beach home location to conduct business in South Carolina. His business activity is what makes his overnight stays at the beach home business stays.

How Rental Use Changes the Landscape

If you rent the vacation home or condo, you really change the tax picture. For example, if you use the vacation home or condo for personal, business, and rental purposes, you could trigger

- vacation-home rules that require a split between the rental- and personal-use deductions;
- vacation-home rules that classify the rental part of your property as either a personal residence or a rental property;
- loss of tax-favored hotel status for qualified rentals; and
- passive-loss rules that defer current tax benefits to future years.

Looking at this list, you might ask, "How can I avoid all these additional considerations and still rent out the vacation home or condo?" Answer: rent for 14 days or less.[6] Technically, that works.

But then what happens if you use the vacation home for personal, rental, and business purposes during a year? Neither Congress nor the IRS gives guidance in this situation. We think it's logical to deduct

- the business portion under the business rules, and
- the personal and rental uses under the vacation-home rules.

But keep in mind that rental of the vacation home or condo changes your strategy.

Don’t Entertain

In *Ireland*, the court said any use of the beach home for entertainment, no matter how minor, fatally dooms the claimed entertainment-facility deduction because Section 274(a)(1)(b) operates as an absolute bar to a facility deduction when there is any entertainment.[7]

Under the Tax Cuts and Jobs Act (TCJA), business entertainment is no longer tax deductible. That’s good, since all entertainment did for your vacation home or condo was kill the deductions. So, don’t entertain at your vacation home or condo.

Business meals are not entertainment and are deductible under the TCJA, and you can serve them during your business use of the vacation home or condo.

Avoid the Good Deed

And then there is the “no good deed goes unpunished” tax code rule that works like this. Say you donate a week at your business vacation home or condo to the local cancer society for its silent auction.

1. No matter how much the charitable contributor pays for use of your condo, the rules count that donated week as a week of personal use by you.[8]
2. To make matters even worse, the regulations allow no tax deduction for your donation of the business condo for that week—a little tax-law double whammy on this donation.[9]

Build Proof

In addition to keeping receipts for the business condo’s expenses and improvements, you need to prove how many nights you slept in the vacation home or condo for both business and personal purposes.

Notations on your business and personal calendars are helpful but not conclusive. For your business activities, you want proof of why you had to be at the beach home.

Example 3. Sara sells real estate at both her tax and beach home locations. She tracks her prospects and activities at each location.

Do as Sara does. Also, keep your eyes open for third-party and other corroborative evidence of use. Do you have emails, letters, and other proof of why you had to travel to the beach home? If so, print the emails and save them along with the written letters in your tax file.

Do you have evidence of being in the area, such as gas, grocery, and dining receipts?

Proving use of your business condo is easy and takes very little time. Documentation is essential. Don't pass over this critical step.

Ownership

Do you own the vacation home or condo in your personal name?

If so, and you operate as a

- proprietorship or LLC taxed as a proprietorship, no problem. Simply treat the business percentage as business expenses on your Schedule C.
- corporation, submit an expense report to the corporation to obtain reimbursement.

Why not use a rental arrangement with your corporation? Because you are an employee who likely uses the vacation home or condo for more than 14 days of personal use, you want to avoid a rental arrangement that could cost you your depreciation, repairs, and similar expenses.

The reimbursement method works and creates no complications. Use it.

If the corporation owns the vacation home or condo, you should reimburse the corporation for your personal use so as to avoid the monies showing on your W-2 and increasing payroll taxes on both you and your corporation.

Takeaways

Your use of a vacation home or condo for only business and personal purposes creates a straightforward deduction for the business-use percentage with few complications.

If you own the vacation home or condo personally and operate your business as a corporation, you should submit an expense report to the corporation for reimbursement of the expenses.

Make sure you have a handle on the tax home rules. You want to know that your overnight stays at the vacation home or condo are overnight business stays.

When you add rentals to your business vacation home or condo, you can trigger the vacation-home rules and then your tax life becomes more complicated.

When it comes to using the condo for entertainment, forget it. Be a chicken, dodge the courts, and save yourself a lot of trouble.

Finally, gather the proof to protect your business vacation-home or condo deductions. You need to prove both (a) the cost of operating the vacation home or condo and (b) your percentage of business use.

[1] IRC Section 280A(f)(4).

[2] Ibid.

[3] Edward W. Andrews v Commr., 1st Cir (Apr. 24, 1991), Docket No. 90-2165, footnote 6.

[4] Congressional Record, December 16, 1981, p. 31973.

[5] Congressional Record, December 16, 1981, p. 31968.

[6] IRC Section 280A(g).

[7] Thomas Brown Ireland v Commr., 89 T.C. No. 68.

[8] Rev. Rul. 89-51.

[9] Reg. Section 1.170A-7(a)(1).

Know This if You Have Rental and Personal Use of a Vacation Home

When you have both rental and personal use of a home at the beach or in the city, you have what the tax law calls a vacation home.

That's the beginning of the story.

In this section, you learn how the tax law treats a mixed-use vacation home that the law classifies as a personal residence.

The TCJA included two important changes that can negatively affect vacation homes treated as personal residences.

But there's more. How you use your vacation property during the year can also affect your federal income tax results.

Here's what you need to know, starting with the necessary background information.

Limits on Property Tax Deductions

Before the TCJA, you as an individual taxpayer could claim itemized deductions for an unlimited amount of personal state income and local property taxes. That was then. This is now.

For 2018-2025, the TCJA limits itemized deductions for personal state income and local property income taxes to a combined total of only $10,000, or $5,000 for those who use married filing separate status.[1]

The state income and local property tax limits come into play when you have a vacation home that's classified as a personal residence.

Limits on Qualified Residence Interest Expense Deductions

For 2018-2025, the TCJA also placed new limits on the amount of home mortgage debt for which you can claim itemized qualified residence interest deductions. Before the TCJA, you could deduct interest on up to $1 million of *home acquisition indebtedness* (meaning debt you incurred to buy or improve a first or second residence), or $500,000 if you used married filing separate status.

Before the TCJA, you could also deduct the interest on another $100,000 of *home equity indebtedness*, or $50,000 if you used married filing separate status.

So, before the TCJA, the debt limit for deductible home mortgage interest was really $1.1 million, or $550,000 if you used married filing separate status.

2018-2025 Rules for Deducting Interest on Home Acquisition Debt

For homes purchased during 2018-2025, the TCJA generally allows you to treat interest on up to $750,000 of home acquisition indebtedness incurred to buy or improve a first or second residence as deductible qualified residence interest. If you use married filing separate status, the debt limit is halved to $375,000.[2]

Grandfather Rules for Home Acquisition Debt

Under one grandfather rule, the TCJA change does not affect interest deductions on up to $1 million of home acquisition indebtedness that you took out

- before December 16, 2017, or
- under a binding contract that was in effect before December 16, 2017, as long as your home purchase closed before April 1, 2018.

Under a second grandfather rule, the TCJA change does not affect interest deductions up to $1 million of home acquisition indebtedness that you took out before December 16, 2017, and then refinanced later—to the extent the initial principal balance of the new loan does not exceed the principal balance of the old loan at the time of the refinancing.[3]

Deducting Home Equity Loan Interest Is Generally Off Limits for Now

For 2018-2025, the TCJA generally suspends the prior-law provision that allowed you to treat interest on up to $100,000 of home equity indebtedness, or $50,000 if you use married filing separate status, as deductible qualified residence interest.[4]

But you can treat home equity indebtedness as home acquisition indebtedness, subject to the $750,000/$375,000 limit, if the loan proceeds were used to buy or improve your first or second residence and the loan is secured by that residence.

TCJA Impact on Vacation Properties Not Rented During the Year

If you own a vacation property that you don't rent out at all during the year, you treat the property as a *personal residence* for federal income tax purposes. As you know from above, the TCJA changes can reduce or eliminate your allowable itemized deductions for vacation home property taxes and mortgage interest.

For instance, say you pay heavy state income taxes. In this scenario, you may lose all your property tax deductions and likely some income tax deductions too.

Vacation Properties Rented for Less Than 15 Days Get a Special Tax Break

Do you rent out your vacation property for less than 15 days during the year and use it for personal purposes for more than 14 days during the year? If the answer is yes, you qualify for a special tax break.

You need not declare a penny of the rental income on your Form 1040, because the rental activity is completely disregarded for federal income tax purpose.[5] Nice!

The only drawback is that you get no deductions for other expenses attributable to the rental period, such as advertising and cleaning costs. This beneficial tax-law quirk has been around for many years and, thankfully, it survived the TCJA.

Tax-Law Definition of Vacation Home

We will call vacation properties that you use partly for rental purposes and partly for personal purposes during the year *mixed-use* vacation properties. Under the vacation home rules, those mixed-use properties will be classified as either

- personal residences (where special allocations are necessary) or
- rental properties (where special allocations also are necessary).

To keep this section from turning into a book, we will cover only the mixed-use vacation home personal residence here. You have such a mixed-use personal residence, whether in the city or at the beach, when you[6]

- rent it for more than 14 days during the year and
- use it for personal purposes for more than the greater of 14 days or 10 percent of the days that you rent the home out at fair market rates.

Counting Days of Use

To determine if your mixed-use property is subject to the vacation home rules, you count only actual days of personal and rental occupancy. Ignore days of vacancy. Also ignore days that you spend mainly on repair and maintenance activities.[7]

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. For this purpose, family members are defined as the owner’s brother, sister, spouse, ancestor, or lineal descendent.

Family Trouble

Use by a family member generally counts as personal use whether or not the family member pays fair market rent.[8]

Swap Trouble

If the home is used by another person under a reciprocal arrangement ("I use your vacation property and you use mine"), such use is considered personal use—whether or not the other person pays you fair market rent to use your property and whether or not you pay fair market rent to use the other person's property.[9]

Example: The mixed-use vacation home personal residence.

You own a beachfront vacation condo. During the year, you rent it out for 180 days. You and members of your family stay there for 90 days. The property is vacant the rest of the year except for seven days at the beginning of winter and seven days at the beginning of summer, which you spend maintaining the property. Your condo falls into the tax code-defined personal residence because

- you rented it out for 180 days, which is more than 14 days and
- you had 90 days of personal use, which is more than 14 days and more than 10 percent of the rental days.

Disregard the 14 days you spent maintaining the place.

Variation. Say you had only 14 days of personal use. Now your condo is considered a rental property, rather than a personal residence, and it triggers a different set of allocation possibilities and disallowance rules.

Tax-Law Definition of Rental Property

Remember, tax law classifies your mixed-use home as a *rental property* rather than a vacation home for federal income tax purposes if

- you rent it 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 place out at fair market rates.

Remember also that you count only actual days of rental and personal use. Disregard days of vacancy, and disregard days spent mainly on repair and maintenance activities.

Key point. As stated earlier, this section does not cover the separate set of federal income tax rules that apply to mixed-use properties classified as rental properties.

Personal Residence Allocations to Personal and Rental Use

When the vacation home rules make your mixed-use property a personal residence, the TCJA limitations on itemized deductions for property taxes and mortgage interest come into play for 2018-2025.

The fundamental principle determining when your vacation home is a personal residence is that expenses allocable to rental use of the property cannot exceed the *gross rental income* from the property. In other words, rental expenses cannot cause a tax loss on Schedule E of your Form 1040 for the year in question.[10]

Fair enough, but we need a procedure to allocate expenses between personal and rental use. The tax code provides such an allocation procedure and also the related tax return treatments, which are as follows.[11]

Step 1. Determine your gross rental income. Gross rental income equals gross receipts from rental reduced by expenditures to obtain tenants, such as Realtor® fees and advertising expenses. Report the amounts on Schedule E of your Form 1040.

Step 2. Use the actual days of rental and personal use to allocate both interest from the home acquisition indebtedness and the real property taxes to rental and personal use. Deduct the rental portion to the extent it does not exceed gross income on Schedule E. Deduct the personal interest and property taxes on Schedule A.

Key point. In the unusual circumstance where Step 2 shows a loss, recalculate Step 2 applying the interest limitation rules and the $10,000 cap on taxes. If such a calculation shows a loss, it's deductible as a loss and you carry over to next year the expenses under Steps 2 and 3 below.

Key point. In some cases, you will deduct none of the property taxes allocable to personal use on Schedule A because you either claim the standard deduction or suffer from the $10,000 limit on state income and local property taxes. You will see an illustration of this in the sidebar at the end of this section.

Step 3. Deduct on Schedule E (to the extent they do not exceed the remaining gross income) expenses allocable to rental use (other than those that would result in an adjustment of basis) such as property insurance, HOA fees, utilities, and maintenance.

Step 4. Deduct depreciation and other adjustments to basis to the extent such deductions do not exceed gross income from the rental. If depreciation is limited, reduce the tax basis of your residence only by the currently deductible amount.

Step 5. Carry over any disallowed expenses allocable to rental use from Steps 3 and 4 to your next tax year. In that year, the expenses are again subject to limitation based on that year's gross rental income.[12]

Presumably, if you sell the property, you can use any gain attributable to the rental-use portion of the property to "free up" prior-year disallowed expenses allocable to rental use. (The IRS has given us no guidance on this.)

Two Methods for Allocating Interest and Taxes

The IRS position is that you should use only actual days of personal and rental occupancy to allocate vacation home expenses.[13] As mentioned earlier, you disregard days devoted mainly to repairs and maintenance.

Key point. There's a controversy regarding how to allocate mortgage interest and property taxes that could otherwise be claimed as itemized deductions. Two appeals courts decisions say that to allocate these two expenses, vacation home owners can count actual rental occupancy days as rental days and all other days—including days the property is vacant—as personal days. This is what we will call the *Bolton/McKinney* method for allocating those two expenses.[14]

Before the TCJA, using the *Bolton/McKinney* method was often beneficial because

- it allocates *more* mortgage interest and property taxes to Schedule A (where you could usually currently deduct those expenses under the pre-TCJA rules) and
- it allocates *less* mortgage interest and property taxes to Schedule E, which allowed you to currently deduct more of your other expenses allocable to rental use (property insurance, HOA fees, utilities, depreciation, etc.) on Schedule E when applying the rental income limitation.

But with the TCJA's limitations on itemized deductions for mortgage interest and state and local taxes, using the *Bolton/McKinney* method might be counterproductive. Or it might be helpful. It depends on your specific situation. Confusing?

You bet! See the SIDEBAR at the end of this section for some examples that help clarify things.

Impact of TCJA Increases to Standard Deduction Amounts

Using the IRS-approved method to allocate more vacation home mortgage interest and property taxes to Schedule E might be beneficial if your increased standard deduction ($25,900 for 2022 for married joint-filing couples, $19,400 for heads of households, and $12,950 for singles)[15] would make using the alternative *Bolton/McKinney* method counterproductive.

That's because the *Bolton/McKinney* method shifts more interest and taxes to Schedule A, but if you still don't have enough itemizable expenses to exceed your standard deduction, the amounts shifted to Schedule A will never deliver any tax benefit.

On the other hand, using the IRS-approved method to shift more interest and taxes to Schedule E will deliver a tax benefit, although it may be only a future benefit if the shifted expenses are not currently deductible due to the rental income limitation.

Takeaways

When you use a property for both personal and rental purposes, you need to know the vacation home rules.

And for years 2018-2025, the TCJA limits on itemized deductions for qualified residence interest and property taxes add to the decision-making matrix.

For example, because of the TCJA, some vacation home owners might benefit from using the *Bolton/McKinney* method for allocating mortgage interest and property taxes. Others might benefit from using the IRS-approved method. Now, because of the TCJA, you need to run the numbers to find out.

In any given year, you may be able to micro-manage the number of rental and personal-use days. Your usage pattern may differ from the pre-pandemic norm. That usage pattern can potentially result in better or worse tax outcomes for you, especially when it flips your place from a rental to a residence or vice versa.

For instance, you and family members may be anxious to spend more time at your property at the beach and less time in the big city. That could put the property firmly into personal residence status and possibly increase your allowable itemized deductions for qualified residence interest and property taxes.

But if you're adversely affected by the TCJA limitations on qualified residence interest expense and property taxes, adding more personal-use days may simply result in more lost deductions (a distasteful result).

On the other hand, rental demand for your place may be so high that it's impossible to ignore the opportunity to collect more rental income. That could put the place firmly into rental property status and make it subject to a different set of federal income tax rules that apply to rental properties. We're covering these in an upcoming issue.

Under those rules, you can usually offset all of your rental income with allowable deductions on Schedule E of Form 1040. If so, adding more rental days could result in more tax-sheltered rental income, which would be a good thing.

SIDEBAR: Three Examples of How to Allocate Vacation Home Expenses

Example 1. Allocating vacation home expenses.

Wanda is a married joint-filer who owns a beachfront condo in Florida that's rented out three months during 2021 at market rates, used by Wanda and her family for two months, and vacant for the remaining seven months because the family deems it too hot and humid.

The property is a residence under the vacation home rules because it's rented more than 14 days and used for personal purposes for more than 14 days and more than 10 percent of the rental days.

The property's income and expenses for 2021 are as follows:

- Gross rental income $21,000
- Interest on vacation home acquisition debt $16,000
- Property taxes $8,000
- Other expenses $20,000

- Depreciation $15,000

Using the five-step procedure explained earlier, the first step is to allocate interest and property taxes. Using the *Bolton/McKinney* method, 25 percent (3/12) of the interest and property taxes are allocable to rental use and 75 percent (9/12, which includes the seven months of vacancy) are allocable to personal use. So, $12,000 of interest (75 percent x $16,000) and $6,000 of property taxes (75 percent x $8,000) can potentially be written off as itemized deductions on Wanda's Schedule A.

The second step is to reduce the rental income by the mortgage interest and property taxes allocable to rental use. So, the $21,000 of rental income is reduced by $4,000 of interest (25 percent x $16,000) and $2,000 of taxes (25 percent x $8,000). These amounts appear on Wanda's Schedule E as rental expenses along with the $21,000 of rental income. At this point in the five-step gauntlet, the interest and property taxes have been fully accounted for, and there's still $15,000 of rental income remaining ($21,000 - $4,000 - $2,000) to be offset by other expenses allocable to rental use.

In the third step, the $20,000 of other expenses, such as HOA fees, property insurance, utilities, maintenance, and so forth, are allocated between rental and personal use based on actual days of rental and personal occupancy.

So, Wanda allocates $12,000 (3/5 of $20,000) to rental and 40 percent (2/5 or $8,000) to personal. The $8,000 is permanently non-deductible and has no effect on Wanda's tax situation. At the end of Step 3, Wanda has $3,000 of gross income remaining for offset ($15,000 - $12,000).

In the fourth step, Wanda allocates $9,000 of depreciation to the rental (60 percent x $15,000). But she can deduct only $3,000 because of the gross income limitation.

In the fifth step, Wanda reduces the basis in her home by $3,000 and carries the remaining $6,000 of depreciation to next year.

In this example, Wanda's Schedule E shows a net of zero: $21,000 of rental income - $4,000 of mortgage interest - $2,000 of property taxes - $12,000 of other expenses - $3,000 of depreciation.

Summary. When all is said and done, $18,000 of Wanda's $59,000 of mixed-use home expenses went to Schedule A, $21,000 went to Schedule E to be currently deducted against the rental income, $6,000 was carried over to 2022 for possible deduction on Schedule E, and $14,000 is permanently non-deductible. This is not a terrible tax outcome.

Example 2. More on allocating vacation home expenses.

As stated earlier, the IRS wants taxpayers to allocate interest on vacation home acquisition indebtedness and property taxes in the same fashion as other expenses—using actual days of rental and personal occupancy. So, what happens if we do that with Wanda's facts for 2022?

Assume the same basic facts as in Example 1, except this time Wanda uses the IRS-approved method to allocate all the vacation home expenses, including mortgage interest and property taxes.

Further assume that this time Wanda cannot claim any itemized deduction for the vacation home mortgage interest because she has an expensive principal residence with a big mortgage that soaks up all of her allowance for home acquisition indebtedness.

Finally, further assume that Wanda cannot claim an itemized deduction for any of the vacation home property taxes because property taxes on her expensive principal residence soak up her entire $10,000 allowance for state and local taxes.

Using the IRS-approved method on the mixed-use property results in allocating 40 percent of the interest and taxes, or $9,600 (40 percent x $24,000), to personal use with no resulting Schedule A deductions for the reasons stated above, and 60 percent, or $14,400 (60 percent x $24,000), to Schedule E where that amount of interest and taxes can be currently deducted against rental income.

- The $35,000 of other expenses are also allocated 60/40 between rental and personal used based on actual days of rental and personal occupancy. So, 60 percent of the $35,000 of other expenses, or $21,000, is allocated to rental and 40 percent, or $14,000, to personal. The $14,000 allocated to personal is non-deductible and has no effect on Wanda's tax situation.
- The $21,000 of other expenses allocated to rental use consists of $9,000 of depreciation (60 percent x $15,000) and $12,000 of other expenses (60 percent x $20,000) such as HOA fees, property insurance, utilities, maintenance, and so forth. Wanda can currently deduct only $6,600 of the other expenses on Schedule E because of the rental income limitation ($21,000 rental income - $14,400 of allocable mortgage interest and property taxes = $6,600). The remaining $14,400 of other expenses allocable to rental use ($21,000 - $6,600) are disallowed for 2022.

Wanda accounts for the $14,400 of disallowed allocable rental expenses by carrying them forward to her 2023 return for possible deduction on Schedule E in that year. The carryover amount consists of $9,000 of depreciation and $5,400 of other expenses.

Outcome: When all is said and done after using the IRS-approved allocation method for Wanda's $59,000 of mixed-use home expenses,

- $9,600 of interest and property taxes were allocated to personal use with no Schedule A deductions allowed due to the TCJA limitations,
- $21,000 was allocated to Schedule E and currently deducted against rental income,
- $14,400 was carried over to 2023 for possible deduction on Schedule E in that year, and
- $14,000 of other expenses allocable to personal use were permanently non-deductible.

So, a total of $23,600 ($9,600 + $14,000) is permanently non-deductible. Ugh!

Alternative: If under the facts in this example Wanda instead uses the *Bolton/McKinney* method to allocate mortgage interest and property taxes, $18,000 of those expenses (75 percent x $24,000) would be permanently non-deductible due to the TCJA limitations.

Wanda can currently deduct $21,000 of allocable rental expenses (including $6,000 of allocable mortgage interest and property taxes and $15,000 of allocable other expenses against rental income on Schedule E. $20,000 of disallowed other allocable rental expenses ($35,000 - $15,000) would be carried over to 2023 for possible deduction on Schedule E.

So, using the *Bolton/McKinney* allocation method would result in "only" $18,000 of permanently non-deductible expenses ($12,000 of mortgage interest and $6,000 of property taxes), while using the IRS-approved allocation method would result in $23,600 of permanently non-deductible expenses as explained earlier in this example.

For the particular facts in this example, using the *Bolton/McKinney* method delivers a better tax result. But that won't always be the case. You must run the numbers to find the best method for your specific situation.

Example 3. One more example.

Same basic facts as in Example 1, except this time assume that there's no mortgage on Wanda's mixed-use home. Further assume that she cannot claim any itemized deduction for the mixed-use home's property taxes because taxes on her principal residence soak up her entire $10,000 allowance for state and local taxes.

So, in this scenario, we want to allocate the $8,000 of vacation home property taxes using the IRS-approved method based on actual days of usage. That way, we can allocate more property tax expense to Schedule E where it can be currently deducted.

Using the IRS-approved method results in allocating 40 percent of the property taxes, or $3,200 (40 percent x $8,000), to personal use with no resulting Schedule A deductions for the reason stated above and 60 percent, or $4,800 (60 percent x $8,000), to Schedule E where that amount can be currently deducted against rental income.

- The $35,000 of other vacation home expenses are also allocated 60/40 between rental and personal use based on actual days of rental and personal occupancy. So, 60 percent of the $35,000 of other vacation home expenses, or $21,000, is allocated to rental and 40 percent, or $14,000, to personal. The $14,000 allocated to personal is non-deductible and has no effect on Wanda's tax situation.
- The $21,000 of other expenses allocated to rental use consists of $9,000 of depreciation (60 percent x $15,000) and $12,000 of other expenses (60 percent x $20,000) such as HOA fees, property insurance, utilities, maintenance, and so forth. Wanda can currently deduct $16,200 of the $21,000 on Schedule E because of the rental income limitation ($21,000 rental income - $4,800 of allocable property taxes =

$16,200). The remaining $4,800 of other expenses ($21,000 - $16,200) allocable to rental use is disallowed for 2021.

Wanda accounts for the $4,800 of disallowed allocable rental expenses by carrying them forward to her 2023 return for possible deduction on Schedule E. The carryover amount consists of $4,800 of depreciation.

Outcome: When all is said and done for Wanda's $43,000 of vacation home expenses,

- $3,200 of property taxes were allocated to personal use with no Schedule A deduction allowed due to the TCJA limitation,
- $21,000 of expenses were allocated to Schedule E and currently deducted against rental income,
- $14,000 of other expenses allocable to personal use were permanently non-deductible, and
- $4,800 was carried over to 2022 for possible deduction on Schedule E.

So, a total of $17,200 ($3,200 + $14,000) is permanently non-deductible.

The remaining $25,800 ($21,000 + $4,800) is deducted currently or carried forward to 2023 for possible deduction in that year.

For the particular facts in this example, using the IRS-approved method for allocating property taxes delivers a better result because it allows Wanda to deduct more property tax expense.

But as you know, you must run the numbers to find the best method for your specific situation.

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[1] IRC Section 164(b)(6).

[2] IRC Section 163(h)(3)(F)(i)(II).

[3] IRC Sections 163(h)(3)(F)(i)(III); 163(h)(3)(F)(iii).

[4] IRC Section 163(h)(3)(F)(i)(I).

[5] IRC Section 280A(g).

[6] This definition is found in IRC Section 280A(d)(1). Note that properties covered by the Section 280A vacation home rules are not subject to the dreaded passive activity loss (PAL) rules, per IRC Section 469(j)(10).

[7] Prop. Reg. Section 1.280A-1(e)(4).

[8] The only exception is when the family member uses the home as his or her principal residence and pays fair market rent [IRC Section 280A(d)(3)(A)].

[9] IRC Section 280A(d)(2)(B).

[10] Gross rental income is defined as total rental income minus direct expenditures to obtain tenants such as commissions paid to realtors or rental agents and advertising expenses. IRC Section 280A(c)(5); Prop. Reg. 1.280A-3(d)(2).

[11] Prop. Reg. Section 1.280A-3(d)(3).

[12] IRC Section 280A(c)(5).

[13] Prop. Reg. Sections 1.280A-3(c); 1.280A-3(d)(3).

[14] Dorance Bolton, 51 AFTR 2d 83-305 (9th Cir. 1982); Edith McKinney, 52 AFTR 2d 83-6281 (10th Cir. 1983).

[15] Rev. Proc. 2021-45.

Vacation Home Rental—What's Best for You: Schedule C or E?

Do you have a beach or mountain home that you rent out?

If so, you likely have a choice—either

- claim the income and expenses on Schedule C, or
- claim the income and expenses on Schedule E.

When Is Schedule C a Good Choice?

If you show a tax loss on your rental property, Schedule C is a great choice because it allows you to deduct your rental losses against all other income (assuming you materially participate in the rental property, as discussed later).

If you show taxable income on the rental property, Schedule C is not good because it causes you to pay self-employment taxes.

When Is Schedule E a Good Choice?

If you show taxable income on the transient rental, Schedule E is best because you don't pay any self-employment taxes on Schedule E income.

If you show a loss on your transient rental and you materially participate, you can deduct your losses against all other income, but those Schedule E losses do not reduce self-employment income.

Okay, now you know how to play the game.

Controlling Regulation

IRS Reg. Section 1402(a)-4(c)(2) states:[1]

Services rendered for occupants. *Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently, such payments are included in determining net earnings from self-employment.*

Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

IRS in Summary Mode

In recent advice, the IRS stated that rentals of living quarters are not subject to self-employment tax when no services are rendered for the occupants.[2]

But if services are rendered for the occupants, and the services rendered

1. are not clearly required to maintain the space in a condition for occupancy, and
2. are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent,

then the net rental income received is subject to the self-employment tax.

Example

John owns and rents a fully furnished vacation property via an online rental marketplace.

John provides linens, kitchen utensils, and all other items to make the vacation property fully habitable.

John also provides daily maid services, including delivery of individual-use toiletries and other sundries; access to dedicated Wi-Fi service for the rental property; access to beach and other recreational equipment for use during the stay; and prepaid vouchers for ride-share services between the rental property and the nearest business district.

During the year, the average period of customer use of the vacation property is seven days, which means it is not a rental property for purposes of the passive loss rules.[3]

John also materially participates in the property, which means it is an activity not subject to the passive loss rules.[4]

Per the IRS, John's facts are such that his rental activity is subject to the self-employment tax.[5]

Observations

John's rental activity is commercial because he is renting to transients. This means he must use 39-year depreciation.

The good news is, John gets immediate deductions for qualified improvements.

The definition of services that trigger the self-employment tax is different from the definition of services that allow properties to escape "real estate professional" status (as defined by the tax law) under the passive loss rules.

Takeaways

If your rentals produce tax losses, you want to deduct those losses on Schedule C, where they reduce your income from all sources. The trick to getting the losses on Schedule C is to rent to transients, materially participate, and provide services.

If your rental shows income, the last place you want to report that rental is on Schedule C, where it triggers the self-employment tax. You can avoid the Schedule C classification by limiting the services you provide.

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[1] Reg. Section 1.1402(a)-4(c)(2).

[2] CCA 202151005.

[3] Reg. Section 1.469-1T(e)(3)(ii)(A).

[4] Reg. Section 1.469-5T.

[5] CCA 202151005.

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[1]

- 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.[2]

"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.[3]

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.[4]

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.[5]

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.[6]

"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.[7]

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

The IRS says the $25,000 small landlord exception is not allowed[8]

- 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 the rules explained in Vacation Home Rental—What's Best for You: Schedule C or E?

"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.[9]

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.[10]
- You spend more than 100 hours dealing with the property, and no other person spends more time on this property than you.[11]
- You spend more than 500 hours dealing with the property.[12]

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, as explained in Vacation Home Rental—What's Best for You: Schedule C or E?

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 section.

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.

Under the tax code rules, that vacation home is either

- a personal residence, or
- 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 section, 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.

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.

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[1] IRC Section 280A(d)(1).

[2] Prop. Reg. Section 1.280A-1(e)(4).

[3] IRC Section 280A(d)(2)(B). Use by family members (defined as the owner's brother, sister, spouse, ancestor, or lineal descendent) counts as personal use whether or not fair market rent is

paid. The only exception is when the home is used by the family member as his or her principal residence and fair market rent is paid. See IRC Section 280A(d)(3)(A). This type of use is fairly unusual, but if it occurs, it is considered rental use rather than personal use.

[4] IRC Section 280A(e).

[5] IRC Section 163(h)(4)(A).

[6] IRC Section 469 and related IRS regulations.

[7] IRC Section 469(i).

[8] Temp. Reg. Section 1.469-1T(e)(3)(ii)(A); TAM 9505002.

[9] IRC Section 469(c)(7).

[10] Temp. Reg. Section 1.469-5T(a)(2).

[11] Temp. Reg. Section 1.469-5T(a)(3).

[12] Temp. Reg. Section 1.469-5T(a)(1).

Selling Your Highly Appreciated Vacation Home? What About Taxes?

With many real estate markets still surging, especially in sought-after places, you may be thinking about selling a vacation home that's gone way up in value.

But what about the tax hit? Good question.

While the federal income tax home sale gain exclusion break is still on the books, it's only available for the sale of a principal residence.[1] That said, a vacation home will sometimes qualify for the gain exclusion break if you've also used the property as a principal residence.

- This section explains in plain English the sometimes-complicated federal income tax rules for gains from selling a vacation home. Let's get started.

Scenario 1: You Have Never Rented Out the Vacation Home

In this scenario, the vacation home is your second home and thus the principal residence gain exclusion break is obviously unavailable. Your profit will be treated as a capital gain and taxed accordingly.

If you've owned the property for more than one year and never rented it out, you'll owe federal capital gains tax at the lower rates for long-term capital gains. The maximum rate for long-term capital gains is 20 percent. But you'll owe that rate only on the lesser of (1) your net long-term capital gain or (2) the excess of your taxable income, including any net long-term capital gain, over the applicable threshold.

For 2022, the thresholds are $517,200 if you're a married joint filer, $459,750 if you're a single filer, and $488,500 if you use head of household filing status.[2]

If you also owe the 3.8 percent net investment income tax (NIIT), the maximum effective federal rate on your net long-term capital gain will be 23.8 percent: the advertised 20 percent rate plus another 3.8 percent for the NIIT.

Thanks to the thresholds for the 20 percent rate, the advertised rate on long-term capital gains is often "only" 15 percent. But if you owe the NIIT, the effective rate is 18.8 percent (15 percent + 3.8 percent).

You may owe state income tax too.

Example 1. You're a joint filer with 2022 taxable income of $750,000, consisting of a $500,000 long-term capital gain from selling your highly appreciated beachfront condo and

$250,000 of taxable income from other sources after allowable deductions. The excess of your taxable income over the applicable threshold is $232,800 ($750,000 – $517,200).

- The $232,800 is taxed at the maximum 20 percent rate.
- The remaining $267,200 ($500,000 – $232,800) is taxed at "only" 15 percent.
- You'll also owe the 3.8 percent NIIT on all or part of your long-term capital gain (probably all).
- And you may owe state income tax too.

Example 2. You're a joint filer with 2022 taxable income of $900,000, consisting of a $350,000 long-term capital gain from selling your upscale cabin in the mountains and $550,000 of taxable income from other sources after allowable deductions.

Since your taxable income before any long-term capital gain exceeds the applicable threshold of $517,200, the entire $350,000 long-term capital gain is taxed at the maximum 20 percent rate. You'll also owe the 3.8 percent NIIT on all or part of your long-term capital gain (probably all), and you may owe state income tax too. Ugh! Sorry about that!

Example 3. You're a single filer with 2022 taxable income of $400,000, consisting of a $200,000 long-term capital gain from selling your modest vacation home in a desirable area and $200,000 of income from other sources after allowable deductions.

Since your taxable income including the long-term capital gain doesn't exceed the applicable threshold of $459,750, the entire $200,000 long-term capital gain is taxed at "only" 15 percent. You'll probably also owe the 3.8 percent NIIT on all or part of your long-term capital gain, and you may owe state income tax too. But at least you dodged the 20 percent bullet. Could have been worse!

Scenario 2: You Rented Out the Vacation Home

In this scenario, you've probably deducted depreciation for rental periods. If so, you'll pay a 25 percent federal income tax rate on the amount of gain attributable to the depreciation This unrecaptured Section 1250 gain will usually equal the cumulative amount of depreciation deductions claimed for the property over the years.

Assuming you've held the property for over one year, the remaining gain will be long-term capital gain taxed as explained earlier.

But there's more.

If you rented out the vacation home but also used it more than a little for personal purposes, it has probably been classified as a personal residence for federal income tax purposes. If so, you may have had rental losses that you could not deduct currently (disallowed losses) due to a special loss limitation rule.[3] When you sell the property, you can *apparently* deduct the disallowed losses to the extent of the taxable gain.[4]

We are not done yet.

If you rented out the vacation home but used it only a little for personal purposes, it has probably been classified as a rental property for federal income tax purposes. If so, you may have had rental losses that you could not deduct currently due to the dreaded passive activity loss (PAL) rules (suspended PALs).[5] If so, you can generally deduct the suspended PALs when you sell the property.[6]

Scenario 3: For a Time, You Used the Vacation Home as a Principal Residence

Here's where it can get interesting—in a good way. You might be able to claim the tax-saving principal residence gain exclusion break, depending on your exact situation. Here's how that could work.

Gain Exclusion Basics

Unmarried homeowners can potentially exclude from taxation principal residence gains up to $250,000, and married homeowners can potentially exclude up to $500,000.[7]

<u>Ownership and Use Tests</u>

To take full advantage of the principal residence gain exclusion break, you must pass two tests: the *ownership test* and the *use test*.

- **To pass the ownership test**, you must have owned the property for at least two years out of the five-year period ending on the sale date.
- **To pass the use test**, you must have used the property as your *principal residence* for at least two years out of the five-year period ending on the sale date.
- If you're married and file jointly, you qualify for the bigger $500,000 joint-filer exclusion if (1) either you or your spouse pass the ownership test for the property, *and* (2) both you and your spouse pass the use test.

As you can see, it's possible that you could pass these tests for a property that has been used both as a vacation home and a principal residence. So far, so good. But stay with us.

<u>Anti-Recycling Rule</u>

The other major qualification rule for the home sale gain exclusion break goes like this: the exclusion is generally available only when you've not excluded an earlier gain within the two-year period ending on the date of the later sale. In other words, you generally cannot recycle the gain exclusion privilege until two years have passed since you last invoked the privilege.

You can claim the larger $500,000 joint-filer exclusion only if neither you nor your spouse took advantage of it for an earlier sale within the two-year period. If one spouse claimed the exclusion within the two-year window, but the other spouse did not, the exclusion is limited to $250,000. Once again, so far, so good. But there's more.

Taxes on Profit That Can't Be Sheltered with the Gain Exclusion

If you have a hefty gain from selling a vacation home, it may be too big to fully shelter with the gain exclusion—even if you qualify for the maximum $250,000/$500,000 break. Assuming you've owned the property for more than one year, the part you cannot exclude will produce the tax results explained earlier.

Warning: Little-Known Rule Can Reduce Your Gain Exclusion

Once upon a time, you could simply convert your vacation home into your principal residence, occupy it for at least two years, sell it, and take full advantage of the $250,000/$500,000 gain exclusion privilege. Those were the good old days.

Now, a little-known rule can reduce your otherwise allowable gain exclusion.[8] Let's call the amount of gain that's made ineligible the "non-excludable gain." Calculate the non-excludable gain from your vacation home sale as follows.

Step 1. From your total gain, subtract any gain from depreciation deductions claimed against the property for any rental periods after May 6, 1997. Report that amount of gain as unrecaptured Section 1250 gain on Schedule D of Form 1040 for the year of sale. Carry the remaining gain to Step 3.

Step 2. Calculate the non-excludable gain fraction. The numerator is the amount of time *after 2008* during which you did not use the property as a principal residence, called "non-qualified use."

Fortunately, non-qualified use does not include temporary absences that aggregate to two years or less due to changes of employment, health conditions, or other circumstances specified in IRS guidance.

Non-qualified use also does not include times when the property was not used as your principal residence if those times are (1) after the final day of use as a principal residence and (2) within the five-year period ending on the sale date. (See Example 5 below.)

The denominator of the fraction is your total ownership period for the property.

Step 3. Calculate the non-excludable gain by multiplying the gain from Step 1 by the non-excludable gain fraction from Step 2.

Step 4. Report on Schedule D of Form 1040 the non-excludable gain calculated in Step 3. As explained in Step 1, also report any unrecaptured Section 1250 gain from depreciation. The remaining gain after subtracting the non-excludable gain and any unrecaptured Section 1250 gain is eligible for the principal residence gain exclusion privilege, assuming you meet the timing requirements.

Example 4. You're a married joint-filer. You bought a vacation home on January 1, 2001. On January 1, 2016, you converted the property into your principal residence and lived there with your spouse from 2016 through 2021. On January 1, 2022, you sold the property for a $600,000 gain, including $50,000 of depreciation deductions claimed for the 15-year rental period (January 1, 2001, through December 31, 2015).

You report the $50,000 of gain attributable to depreciation deductions from periods when you rented the place while it was a vacation home (unrecaptured Section 1250 gain) on your 2022 Form 1040. That gain is subject to a federal income tax rate of 25 percent plus another 3.8 percent if the NIIT applies.

Your remaining gain is $550,000 ($600,000 – $50,000).

Your total ownership period is 21 years (2001-2021). The seven years of post-2008 use as a vacation home (2009-2015) result in a non-excludable gain of $183,333 (7/21 x $550,000). Report the $183,333 as long-term capital gain on Schedule D included with your 2022 Form 1040.

You can shelter the remaining $366,667 of gain ($550,000 – $183,333) with your $500,000 joint-filer gain exclusion.

Example 5. You're an unmarried person. You bought a vacation home on January 1, 2013. On January 1, 2016, you converted the property into your principal residence and lived there from 2016 through 2019.

You then converted the home back into a vacation property and used it as such for 2020 and 2021 before selling the property on January 1, 2022, for a $540,000 gain. Your total ownership period is nine years (2013-2021). The first three years of post-2008 use as a vacation home (2013-2015) result in a non-excludable gain of $180,000 (3/9 x $540,000).

Report the $180,000 as long-term capital gain on Schedule D filed with your 2022 Form 1040.

You can shelter $250,000 of the remaining $360,000 gain ($540,000 – $180,000) with your $250,000 gain exclusion. Report the last $110,000 of gain ($360,000 – $250,000) as long-term capital gain on Schedule D filed with your 2022 Form 1040.

Key point. The final two years of use of the property as a vacation home (2020-2021) *don't* count as periods of non-qualified use because they occur (1) after the final day of use as a principal residence (December 31, 2019) and (2) within the five-year period ending on the sale date (January 1, 2022).

Therefore, your use of the property as a vacation home in 2020 and 2021 doesn't make your non-excludable gain any bigger. Fair enough.

Takeaways

The tax-code-defined vacation home rules come into play when you have both rental and personal use of a home. Thus, you can have tax-code-defined vacation homes in the city, in the suburbs, and in recreation areas.

If you have no combined rental and personal use of the home, the rules are easy. The property is one of the following:

- Rental property
- Second home
- Principal residence

But when you have both rental and personal use of the home, your tax life gets more complicated because you have entered the tax code's vacation home section. In this situation, the property in a more complicated way is one of the following:

- Rental property
- Second home
- Your principal residence

If it's a principal residence, then the $250,000/$500,000 home sale exclusion is available when you sell.

If it's simply a second home, you can't use the exclusion and you pay taxes at capital gains rates—and you may suffer the NIIT as well.

If it's a rental, you face the capital gains rules, NIIT, unrecaptured Section 1250 gain taxes, and release of some (if grouped) or all (if not grouped) passive activity suspended losses.

When you have rental use after 2008 and then convert the rental to your principal residence, you must use a rental/residence fraction to determine how you will be taxed.

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[1] IRC Section 121.

[2] Rev. Proc. 2021-45.

[3] The special rule is found in IRC Section 280A and IRS Prop. Reg. 1.280A-3.

[4] IRC Section 280A(c)(5).

[5] The PAL rules are found in IRC Section 469 and related regulations.

[6] IRC Section 469(g).

[7] IRC Section 121.

[8] IRC Section 121(b)(5).

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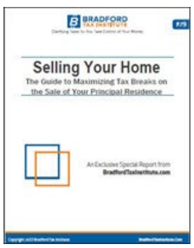
Below are the some of the other popular tax guides we have at the *Tax Reduction Letter.* Click on the links below to access the guides and put these tax-saving strategies to work for you!



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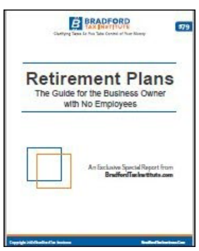

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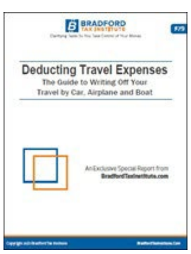
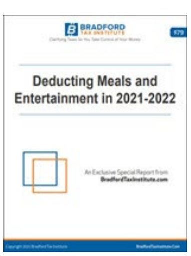


Guide to Deducting Travel Expenses

Whether you travel out of town for business by car, airplane, or boat, you need tax knowledge to create some tax-deductible personal fun days. (Yep, you read that right.) This free guide clarifies the tax law so you can not only ensure your travel deductions, but also turn some personal days into deductible business travel days.



PDF Download: Guide to Deducting Meals and Entertainment in 2022

As a business owner, your expenses for business meals and entertainment for most of 2020 were likely little to zero due to COVID-19. But that will probably change for 2022. And with the new tax law changes, you need to make sure you know the rules so you can maximize your tax savings and deduct up to 100 percent of these expenses.