Owners can maximize tax savings from vacation home

EDITOR'S NOTE: *This is another in the annual series explaining real estate tax laws. New tax developments will be emphasized, but both old and new aspects of each topic will be explained. Reprints of the entire series will be available.*

By **ROBERT J. BRUSS**
Tribune Media Services

If you own a vacation or second home, or are thinking about buying one, consider the income tax savings during ownership and when you sell it. Depending on your personal situation, you might be able to claim substantial tax deductions during ownership.

When you decide to sell, you could make a completely tax-free sale.

The key to maximizing your tax savings from a vacation or second home is keeping careful records, just in case the Internal Revenue Service audits your tax returns. If you document your entitlements, you'll save thousands of tax dollars.

Is your second home your "main home" part of the year?

Millions of snowbirds spend a major portion of each year living in their warm-climate second home, typically in Florida, Arizona, Hawaii or California, and then return to their other residence for the rest of the year.

Depending on the amount of time spent at each home, one property or both might qualify for up to $250,000 home-sale tax-free profits, if you should decide to sell. If you're married and both spouses meet the occupancy test, then up to $500,000 home-sale profits can be tax-free.

To qualify, Internal Revenue Code 121 requires ownership and occupancy of your "main home" an "aggregate" two years during the five years before the sale. Only one spouse needs hold the title. But if both spouses claim the $250,000 exemption, then both spouses must meet this occupancy test.

For example, suppose you live full time in your Florida home from November to April annually, but you move to your other home, full time, from May through October each year. If you decide to sell either of these residences, both meet the aggregate two-year occupancy test.

However, this tax break can only be used once every 24 months, with limited exceptions for job-location changes and health-related moves.

Although secondary residences usually aren't great tax shelters during ownership, they often provide significant tax savings. Here are the four possible situations:

- No personal-use time – If you never occupy your vacation or second home, except for minimal cleaning and repair time, and it is rented or available for rent the entire year, all the rental income and applicable expenses must be reported on Schedule E of your income tax returns. Mortgage interest, property taxes, insurance premiums, utilities, repairs and depreciation can be subtracted from the rental income received.

You probably will have a tax loss if your second home falls into this category. But you must "materially participate" in managing your property. You also must earn less than $100,000 adjusted gross income in 2000 if you are to claim up to $25,000 "passive activity" loss from your rental property against other ordinary, taxable income.

However, if you're a qualified real estate professional, such as a real estate broker, there's no limit to your deductions in this rental-property classification.

- Minimal or no rental time – If you rent your vacation or second home to paying guests fewer than 14 days per year (regardless of the amount of rent received), that rent need not be reported on your income tax returns. But you can fully deduct your mortgage interest, property taxes and any uninsured casualty loss (such as rain or snow damage) as itemized deductions on Schedule A of your income tax returns.

- Annual personal use of more than 15 days or 10 percent of the rental days (if rented more than 14 days per year) – If you or your relatives use your vacation or second home heavily in this category, you cannot deduct any loss from the rental on your income tax returns. But mortgage interest and property taxes are always tax deductible.

For example, if you rented your ski cabin to tenants for 90 days in 2000, and personally used it for 20 days, then you fall into this category.

Schedule E is the place to report the rental income received and applicable expenses. The correct order for deducting expenses is mortgage interest, property taxes, uninsured casualty losses, operating expenses and depreciation.

If mortgage interest, property taxes and uninsured casualty losses exceed the rent received, the excess expenses should be deducted as itemized deductions on Schedule A.

- Annual personal use of fewer than 15 days or less than 10 percent of the rental days that exceed 14 rental days – In this category, if your personal use is fewer than 15 days a year or less than 10 percent of the rental days that exceed 14 days annually, there's no limit to your loss deductions (except for the $25,000 annual passive-activity loss limit explained above).

For example, suppose you rented your summer home to tenants for 120 days last year and personally used it only 10 days, then you are in this category. However, the IRS says the profit motive of Internal Revenue Code 183 applies, requiring a profit at least three out of every five years of your rental activities.