

Owning a second home can create big tax break

By JEFF BROWN

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Let's see ... Here's a nice place on the Outer Banks for a couple hundred thousand. And here's one at Lake Chautauqua for a little less.

What am I doing? Shopping for summer places.

Well, not really shopping — daydreaming, as I amble through the sales listings on the Internet.

Like millions of Americans, I've got lots of summer plans. And like many others, I sometimes think that, gee, it would be nice to have a summer place that's really our own. You know — use it for the family vacation every year ... Build a real tradition ... Maybe rent it a little to offset expenses.

In fact, things are coming together nicely these days for people thinking about purchasing second homes. The real estate market is hotter than it's been in years, especially in popular vacation areas, so the odds of making money on a vacation property are improving.

And thanks to the tax law passed last summer, if you're clever and flexible enough you can earn profit on a second home, tax-free.

"That's absolutely a valid strategy created by the tax law in '97," says Mark Watson, a partner at the accounting and consulting firm KPMG Peat Marwick in Washington, D.C.

The law allows a couple who file a joint return to earn a tax-free profit of up to \$500,000 on the sale of a principal residence, while single taxpayers can earn up to \$250,000 tax-free. To qualify, you must have owned and lived in the home for two of the five years prior to the sale.

The home must be your princi-

pal residence, but it need not be your "only" residence. You could move to the beach place for a couple of years — after you retire, perhaps — spend a couple of years there, sell the home for a tax-free profit, then move back to your home in the city. After another two years, you could sell the city home for a tax-free gain as well.

Watson says there are no hard

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and fast rules about what constitutes a principal residence. If the issue comes up — which is not too common — the IRS would look at factors such as where you spend most of your time, what address you use on your driver's license, where you receive your mail, file your tax return and so forth. It's mainly common sense. Obviously, it would be hard to declare the beach place your principal residence if you're going to a job every day 100 miles away and own a home six blocks from the office.

If you are considering a second home, there are other tax matters to keep in mind.

Generally, the mortgage interest and property tax paid on a second home are tax deductible regardless of how it's used. But if you're thinking of renting the property, the rules get tricky:

■ If you use the home yourself and rent it out for no more than 14 days a year, the rental income is tax-free. But you are not permitted any deductions for rental expenses,

such as paying a leasing agent or cleaning crew.

■ If you use the home yourself and rent it for more than 14 days a year, the rental income becomes part of your gross income and is taxed. But you should be able to deduct some rental expenses.

■ If you use it yourself for more than 14 days a year and rent it for more than 14, it's a "mixed-use" property. If expenses exceed income you cannot declare a loss but can apply the extra expense against income in a future year.

To get the most wide-ranging tax deductions, you must operate the property as a business, which means using it yourself for no more than 14 days a year. In that case, virtually all rental expenses are deductible, including repairs, management fees, utilities, insurance, advertising and depreciation.

If you actively participate in the rental activities — making key decisions about maintenance and rental terms, for instance — you can deduct net rental losses of up to \$25,000 per year if your adjusted gross income does not exceed \$100,000. That maximum deduction gradually decreases to zero as AGI rises to \$150,000.

Does a second home make sense as an investment? It can, says Watson, if the location is hot enough. You may have to operate at a loss for a number of years, but not always, he says.

Still, he says he tells clients only to buy second homes they want to use themselves; otherwise, the hassles and potential expenses are too hard to justify.

"Basically, people should not look at a vacation home as a way of generating a tax-shelter or loss. But renting a house is a great way to service a mortgage."