

TAX SHELTERS TAKE A VACATION

Are you one of the millions of Americans looking at a second home? Vacation homes give you similar tax breaks as your primary home. They also give you the chance to earn tax-free or tax-advantaged income. As the “baby boom” generation grows older and more affluent, vacation home prices are rising, in some areas even faster than primary residences. This combination of income and appreciation is making second homes attractive investments.

You can deduct mortgage interest you pay on up to \$1 million of “acquisition indebtedness” to buy your primary residence and one additional residence. If your total mortgage indebtedness tops \$1 million, you can still deduct the interest you pay on their first \$1 million. If one mortgage carries a substantially higher rate than the second, it makes sense to deduct the higher interest first to maximize deductions.

You don’t need to buy an actual house (or even a condominium) to take advantage of second-home mortgage interest deductions. You can deduct interest you pay on a loan secured by a timeshare, yacht, or motor home so long as it includes sleeping, cooking, and toilet facilities.

You can’t exclude gains from selling your vacation home the way you can for selling your primary residence. But you can still use the exclusion to save tax when you sell your vacation property if you convert it to your primary residence. Let’s say you live in Chicago and you buy a vacation home in Hilton Head. You can sell your Chicago home once your children are grown, and exclude up to \$500,000 in gain. If you move to your Hilton Head home and occupy it as your primary residence, you can sell it two years later and exclude up to another \$500,000 in gain.

You can also rent your home to earn income and help finance the cost of owning the home. If you rent for 14 days or less, your income is tax-free. Longer rentals are taxed according to how long you use it

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personally. (Personal use includes days your family uses the house, days you rent it for below-market rates, days you trade its use for someplace else, and time you donate as a charitable gift, but not days you use to prepare it for rental.)

- If you use it personally for more than the greater of 14 days or 10% of the rental days, it qualifies as residential property. You'll have to report your income—but your expenses may offset it enough to avoid paying tax. To figure the rental portion of mortgage interest and property taxes, divide the days of rental use by 365. For maintenance and utilities, divide the days of rental use by the days of total use (including rental and personal use). You can deduct rental expenses such as advertising, commissions, and travel—but not depreciation. You can deduct expenses up to your income, but not beyond. (Depending on your income, you might still itemize excess mortgage interest and property tax.)
- If you use it personally for less than the greater of 14 days or 10% of rental days, it qualifies as rental property. To figure the rental portion of your mortgage interest, property taxes, maintenance, and utilities, divide the days of rental use by the days of total use. (There's no separate formula for "empty days" with mortgage interest and property taxes as there is when you treat the home as residential property.) You can deduct rental expenses such as advertising, commissions, and travel. And you can deduct depreciation. If the property generates a loss, you can deduct it against outside income if you qualify for the rental real estate loss allowance or you qualify as a real estate professional.

Together, this combination of tax-advantaged income, price appreciation, and vacation fun are making second homes America's favorite investment. For more information, contact our office.

This is intended for general interest and not as specific legal or accounting advice for anyone. You should consult your tax advisor to get more information.