

## How Can You Invest in a Vacation Home and Realize Some Tax Breaks...and Enjoy the Location in a “*Home by the Sea*”.

Are you considering a place in the sun, at the beach, golfing on incredible courses, riding your favorite polo pony, deep sea fishing on your yacht, sailing in wide open safe bays that can bring you to the ocean in a matter of an hour? If you are in the market for a second home you can gain some tax breaks **AND** enjoy a summer time of fun!

**Mortgage Interest:** If you use the property as a second home — rather than renting it out as a commercial property — interest on the mortgage is deductible just as interest on the mortgage on your first home. You can write off 100% of the interest you pay, up to \$1.1 million of debt secured by your first and second homes that was used to acquire or upgrade the properties.

**Property tax:** You can deduct property taxes on your second home. In fact, you can deduct property taxes paid on any number of homes you own.

**If you plan to rent your second home:** Lots of second-home buyers rent their property part of the year to get others to help pay the bills. Very different tax rules apply depending on the breakdown between personal and rental use.

If you rent the property out for 14 or fewer days during the year, you can pocket the cash tax-free. Even if you are charging \$10,000 a week the IRS doesn't want to hear about it. The house is considered a personal residence, so you deduct mortgage interest and property taxes just as you do for your principal home.

If the rental runs more than 14 days, you must report **all** rental income day 1 – 14 plus. You also may deduct rental expenses. That can get complicated because you need to allocate costs between the time the property is used for personal purposes and the time it is rented.

**Example:** If you and your family use a beach house for 30 days during the year and it is rented for 120 days, 80% (120 divided by 150) of your mortgage interest and property taxes, insurance premiums, utilities and other costs would be rental expenses. The entire amount you pay a property manager would be deductible, too. You could claim depreciation deductions based on 80% of the value of the house. If a house is worth \$200,000 (not counting the value of the land) and you are depreciating 80%, a full year's depreciation deduction would be \$5,800. You can always deduct expenses up to the level of rental income you report.

But what if costs exceed what you take in? Whether a loss can shelter other income depends on two things: how much you use the property yourself and how high your income is.

If you use the property more than 14 days, or more than 10% of the number of days it is rented — whichever is more — it is considered a personal residence and the loss can't be

deducted. (But because it is a personal residence, the interest that doesn't count as a rental expense — 20% in our example — can be deducted as a personal expense.)

**Limiting personal use to 14 days:** If you limit personal use to 14 days or 10%, the vacation home is considered a business and up to \$25,000 in losses might be deductible each year. That is why lots of vacation homeowners hold down leisure use and spend lots of time "maintaining" the property. Fix-up days don't count as personal use. The tax savings from the loss (up to \$7,000 a year if you're in the 28% tax bracket) help pay for the vacation home. Holding down personal use means forfeiting the write-off for the portion of mortgage interest that fails to qualify as either a rental or personal-residence expense.

We say such losses might be deductible because real estate losses are considered "passive losses" by the tax law. And, passive losses are generally not deductible. But, there is an exception that might help and protect you.

Example: If your adjusted gross income (AGI) is less than \$100,000, up to \$25,000 of such losses can be deducted each year to offset income such as your salary. (AGI is basically income before subtracting your exemptions and deductions.) As income rises between \$100,000 and \$150,000, however, that \$25,000 allowance disappears. Passive losses you cannot deduct can be stored up and used to offset taxable profit when you ultimately sell the vacation house. Check carefully with your CPA or tax advisor for further direction.

**Tax Free Profit Is Great Profit:** Although the rule that allows home owners to take up to \$500,000 of profit tax-free applies only to your principal residence, there is a way to extend the break to your second home: make it your principal residence before you sell. That's not as crazy as it might sound. Nor is it as lucrative as it used to be.

Some retirees, for example, are selling the big family home and moving full time into what had been their vacation home. Before 2009, this had a very special tax appeal. Once you live in that home for two years, up to \$500,000 of profit could be tax free — including appreciation in value during the years it was your second home. (Any profit attributable to depreciation while you rented the property, though, would be taxable. Depreciation reduces your tax basis and therefore increases profit dollar for dollar.)

Congress has subsequently cracked down on this break for taxpayers who covert a second home to a principal residence. A portion of the gain on a sale of the home is ineligible for the home-sale exclusion of up to \$500,000, even if the then current owner meets the two-year ownership and use tests. The portion of the profit that is subject to tax is based on the ratio of the time after 2008, when the house was a second home or a rental unit, to the total time you owned it.

It can still be a great deal if you have owned your second home for many years before the law changed. Let's say you have owned a vacation home for 18 years and make it your main residence in 2014. Two years later, you sell the property. Since the five years after 2008 it was your second home (2009 through 2013) 25% of the 20 years you owned the

home, only 20% of the gain is taxed. The rest qualifies for the exclusion of up to \$500,000.

This is just one of the tax advantages of real estate ownership. For more tips and information, contact a broker at Coastal Newport Real Estate for tax savings in one of the premier fun spots of the North East Coast of the United States.

You can have your tax break and enjoy it too! We suggest buying in a summer time fun spot where a large majority of the world has heard of or visited – Newport and the surrounding areas of Rhode Island, our local market. We focus on luxury real estate in the million dollar plus price point. We have been helping Buyers and Sellers of prime real estate in Rhode Island for 25 + years. Come to Newport and let us show you around. We will send you information packages of as many fun things to do, as you can possibly imagine.

You can contact us for a personal tour at: [www.coastalnewport.com](http://www.coastalnewport.com) or e-mail [info@coastalnewport.com](mailto:info@coastalnewport.com) Phone (401) 849-7000 Tom Chace – Broker, Kevin Loflin – Buyer Agent and Marc Walz – Buyer Agent - The Coastal Newport Real Estate Team

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