

Vacation Real Estate

With the price of real estate depressed in many parts of the country, you may be thinking of investing in vacation real estate. Before doing so, there are a number of factors to consider. First, clearly identify your objectives. Are you purchasing the house on the beach because the price is depressed, because you would love to enjoy a house on the beach and/or because it has great rental potential. Prioritize your objectives and further break them down by time frame. Perhaps, you need to rent it out now to afford it, but, in the future, it may be only for personal use.

Once you have identified and prioritized your objectives and broken them down chronologically, consider the tax implications if the property is used to meet your objectives. The income tax implications of ownership of vacation real estate depend on the use of the property. If the property is entirely personal use property, the mortgage interest will be deductible so long as the real estate is a qualified second home and the debt is secured by the real estate. There is also a limit on the amount of debt on which interest is deductible which must be considered. The real estate taxes on the vacation real estate will be deductible.

If the property is to be rented at all, you must think of the rental aspect as a business. The rents received are income and the ordinary and necessary expenses of generating that income are deductions (but see the various limitations below). Expenses typically include mortgage interest, real estate taxes, maintenance and utilities. Additional expenses depend on the type of property and what is provided to the tenants. The deductibility of the expenses depends primarily on the use of the property.

If the property is used personally for the greater of 14 days or ten percent of the number of days that the property is rented in a year, the property is considered mixed use property. For mixed use property, you must prorate the expenses between personal use and rental use. Only the mortgage interest and real estate taxes allocable to the personal use are deductible, subject to the rules addressed above. The rental use portion of the expenses are deductible, but only to the extent of the income received. Moreover, there is a particular order in which the expenses must be deducted. Mortgage interest and real estate taxes must be deducted first, then operating expenses and finally depreciation.

If the property is not used personally for the greater of 14 days or ten percent of the rented days, the property is considered rental property and all of the expenses are recorded and deducted against the rental income. Unlike a mixed use property, one can incur a loss on rental property. Such a loss is a “passive loss” and is only deductible to offset passive income unless you actively participate in the rental of real estate, in which case you are entitled to deduct a passive activity loss of up to \$25,000. You should be aware that the ability to deduct such a passive activity loss is further limited based on your Adjusted Gross Income.

Note that there are additional rules if the home is rented out for a total of fourteen or less days per year, only a portion of the home is rented or if it is rented at less than fair market value, all of which are beyond the scope of this article. Purchasing and renting real estate in a state other than your own may have state tax implications. These too must be considered but are beyond the scope of this article. Overall, the income tax rules are difficult and many prohibit you from deducting losses on rental real estate. I strongly recommend that you seek assistance from your tax preparer to understand the implications prior to purchasing the property.

After you have considered the income tax implications of owning a second home, consider the practical implications of ownership which depend on the type and location of the property. If it is a beach house, who will maintain it regularly and who will batten down the hatches if there is a hurricane coming? If it is a condominium in the mountains, who will clean the property and inspect the same after each rental? Is it easier to just rent a house at the beach or a condominium in the mountains?

Finally, only after consideration of the tax and non-tax implications of owning the vacation real estate should you evaluate whether you can afford it and still want to own it. Many people consider this first and purchase the real estate only to realize that the tax and practical implications make it unaffordable or undesirable.

Owning vacation real estate is wonderful for some, but not all. A parcel of real estate may be a “bargain”, but that does not mean that it is the right bargain for you. Consider all aspects of ownership and if it still looks like a good idea, enjoy a cool drink with your feet in the sand for me.

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