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Tax Newsletter

Soak Up Tax Breaks for Vacation Homes

Plan to avoid potential tax pitfalls

Suppose you bought a vacation home so you and your family could enjoy some R&R during the beach or skiing seasons. But you may not be using the place as much anymore now that the kids have grown up and moved away.

Timely tax strategy: Depending on your circumstances, you might rent out the home while you are not using it. Although this can be a hassle, especially for first-time landlords, the tax benefits generally outweigh the inconvenience.

For starters, income you receive from a vacation home rental is taxable just like income you receive from renting out apartment units to tenants or running a B&B. However, you can offset at least part of the resulting tax liability by deducting expenses attributable to the rental activities, including property taxes, mortgage interest, repairs, utilities, insurance, depreciation, etc. In some cases, you may even qualify for a tax loss.

However, if you are not careful, you could fall into a tax trap for excessive personal use. Specifically, if personal use of the vacation home exceeds the greater of 14 days or 10% of the time the home is rented out, the annual deduction for rental expenses is limited to the amount of the rental income. Thus, no tax loss is allowed, although rental income in excess of rental expenses remains taxable.

That is why it is important to keep one eye on your rental activity records and the other on the calendar. Moving things around just a little could salvage tax benefits.

Hypothetical example: You have arranged to rent out your summer cottage for twelve weeks (84 days) at an average rate of \$2,000 per week for a total of \$24,000 in rental income. Initially, you and your family planned on spending one week vacationing there plus five weekends, for an annual total of 17 personal days. The expenses attributable to the rental will come to \$32,000, so you expect to show an \$8,000 loss this year.

As things stand now, you can deduct only \$24,000 in rental expenses. Reason: Your personal use exceeds the applicable tax law limit. However, if you reduce the family's annual personal use to 14 days or less, you can deduct the extra \$8,000.

Note that the entire day is treated as a "personal use day" for tax purposes no matter how many hours you spend at the vacation home. So does any day the home is used by a family member who does not pay a fair rental.

When it is feasible, you can convert personal use days into non-personal days. For instance, a day spent closing up place at the end of the season or making repairs does not count as a personal day if the work is your main reason for being there. It does not matter if other family members come along just to enjoy the great outdoors.

Finally, if you rent out a vacation home for two weeks or less during the year, all of the rental income is tax-free, but you cannot deduct any expenses, either. It is a “wash” as far as taxes are concerned.

Caution: There are other potential tax implications, including limits under “passive activity loss” (PAL) rules if you hand over most of the administrative responsibilities to others. Consult with your professional tax advisors concerning your personal situation.

Watch Out for Special Corporate Tax Trap IRS may impose accumulated earnings tax

With all the uncertainty in the world these days, no one could blame a business owner for wanting to set aside some extra funds for emergencies or slowdowns. But the tax law limits how much you can keep in your cupboards. In the worst-case scenario, a C corporation could be assessed an “accumulated earnings tax” for having too much money on hand.

The accumulated earnings tax is paid *in addition to* the regular corporate income tax. The accumulated earnings tax rate is 20%, or just one percent below the flat tax rate for corporations.

Background: The accumulated earnings tax is intended to discourage hoarding money within a company. It applies to “accumulated taxable income,” defined as the company’s taxable income (with certain adjustments) minus the dividends-paid deduction and an accumulated earnings credit. The minimum tax credit for this purpose is \$250,000 or \$150,000 for certain personal service corporations (PSCs). Note: Unlike many other tax code provisions, these amounts are not indexed for inflation.

In other words, if your corporation’s “rainy-day fund” remains below the \$250,000/\$150,000 threshold for the year, there is no accumulated earnings tax problem. The corporation avoids the tax completely.

If you exceed the minimum credit amount, no penalty is imposed on amounts accumulated for a “reasonable business need.” To qualify under this special safe-harbor rule, you must show that you have a specific plan for using the money in the applicable tax year.

There is no definitive list of reasonable business need exceptions, but the following reasons have qualified in the past:

- Retirement of debt;
- Expansion of the business or replacement of the plant;
- Acquisition of another business through purchase of stock or assets;
- Accumulation of working capital for the business (e.g., to purchase inventory); and
- Investments or loans to suppliers or customers necessary for maintenance of the business.

However, reasons that have not made the grade previously include loans to shareholders and expenditures for their personal benefit loans to friends or relatives of shareholders; investments unrelated to the business; and accumulations to provide against unreasonable hazards

Other factors may come into play. For instance, if you own a business in a volatile industry with wide swings in earnings, you might have a better argument for accumulating cash than other businesses operating in a stable environment. Similarly, if your firm is in a highly competitive field based on cutting-edge technology, you may be more inclined to keep additional funds on hand.

If your company is in the danger zone, consider these steps to strengthen your case for accumulating more cash.

1. Adopt a consistent dividend-paying policy.
2. Obtain expert opinions to support anticipated costs.
3. Do the same for accumulations to safeguard against business hazards.
4. Move expansion plans into the blueprint stage as soon as possible.
5. Keep detailed records of valid business reasons for accumulating earnings in the corporate minutes. This is the best proof your company can have for justifying any excess amounts.

Finally, if your position is unclear, you may arrange to have your company pay out enough dividends to stay below the \$250,000/\$150,000 threshold. Your professional advisors can help you navigate these tricky waters.

Working Out Tax-Free Fringe Benefits **Offer athletic facility to employees**

Of course, you want the “best and brightest” employees working for your company. But it is also important for workers to stay physically fit for their sake as well as yours. One approach to encouraging healthier habits is to provide a tax incentive for working out.

Unfortunately, your company cannot offer gym memberships to employees without any adverse tax consequences. However, there is a possible way to work around the rules.

Background: If your company turns part of its workspace into a gym or other athletic facility, it can provide tax-free access to its employees. Furthermore, the cost of the renovations, including expenses required to conform with the building’s existing structure, are tax-deductible by the company. And your company may also be able to deduct other costs related to the facility such as insurance.

Conversely, the cost of providing gym memberships, or reimbursements for gym memberships, are fully taxable to employees as compensation, regardless of your good intentions. Reason: This fringe benefit meets the statutory definition for a tax exclusion under Section 132(j)(4) of the tax code.

The statutory exclusion allows tax-free use of the facility by eligible employees. Plus, the exclusion is extended to their spouses and dependent children. For these purposes, eligible employees include:

- Current employees;
- Former employees who are retired or left the company due to disability;
- A surviving spouse of an employee who passed away or a spouse of an employee who retired due to a disability;
- Certain leased employees; and
- Partners performing services in a partnership.

Note: To qualify for the statutory exclusion, the facility must be “substantially used” by eligible employees. It cannot be open to the general public or available through membership subscriptions by outsiders.

Furthermore, the facility must be located in a physical space operated by and owned or leased by the company. But it is not required to be part of your main workspace. For example, you might use a facility located around the block. Yet you cannot set up a gym at your personal residence or rent a space in a hotel or a resort.

In addition, access must be available to all employees who want to participate. In other words, you cannot restrict use to only the corporate officers or highly-paid employees. Finally, if your company provides other types of services, such as use of personal trainers or certain classes, the cost cannot be excluded from tax under the statutory fringe benefit. It does not matter if the activity takes place at the business premises or online at the employee’s home or other location.

In conclusion: Work out the details with your professional advisors before you begin any construction. Follow the blueprint to preserve the tax benefits.

IRS Releases New Data

The IRS recently issued its “2025 Data Book” detailing the agency’s activities during its last fiscal year 2025 (FY2025). The report provides a statistical overview of the agency’s operations. Some of the highlights are:

- The IRS processed 271.4 million federal tax returns and supplemental documents, including almost 162.8 million individual income tax returns. Collections exceeded \$5.3 trillion.
- Customer service representatives answered almost 18.6 million calls. Employees at 363 Taxpayer Assistance Centers (TACs) nationwide assisted nearly two million taxpayers.
- There were almost 417 million inquiries using the online “Where’s My Refund?” tool that enables taxpayers to check the status of their tax refunds (up 9% from FY2024).

To view the entire 2025 Data Book, visit www.irs.gov.

Facts and Figures

Timely points of particular interest

Online Searches—Just a few years ago, you could reasonably rely on finding reputable and accurate responses to online inquiries at the top of your search results. Not anymore. Now the first answers are often based on artificial intelligence (AI), responses driven by product placements or out-and-out scams. You might have to scroll past 10-12 entries to find a legitimate search results. Moral of the story: Be wary of misinformation on the web.

Scholarship Credits—The IRS has announced that more than half the states—27 to be exact—have already signed up to participate in the new program offering tax credits for qualified contributions to Scholarship Granting Organizations (SGOs). Under the One Big Beautiful Bill Act (OBBBA), taxpayers can claim a credit of up to \$1,700 for contributions to an SGO located in one of these states. Contact your professional tax advisor regarding your options.

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