

## Rental of Residences and Vacation Homes

Tax reporting of the rental of a taxpayer's residence or vacation home depends on how many days the property is used for rental purposes as opposed to personal purposes. A *residence* or *dwelling* for the purpose of IRC Sec. 280A is defined as a dwelling unit and includes a house, apartment, condominium, mobile home, boat, or similar property. **Residences used personally by the taxpayer generally fall into one of three categories when determining their tax treatment (IRC Sec. 280A):**

1. *Personal Residence with Very Limited Rental Use.* A residence that is rented for fewer than 15 days during the year.
2. *Vacation Home with Both Rental and Personal Use.* Property with (a) personal use that exceeds the greater of 14 days or 10% of rental days and (b) rental use that exceeds 14 days.
3. *Rental Property with Very Limited Personal Use.* Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

The property's designation for tax purposes can change yearly, depending on how the property is used. The property's designation also impacts treatment for sale of the property

### Personal Residence with Very Limited Rental Use

A taxpayer's dwelling is treated as a residence if during the year it is used for personal purposes for more than 14 days, or more than 10% of the number of rental days if greater [IRC Sec. 280A(d)]. If such residence is rented for fewer than 15 days during the calendar year, it is considered solely a personal residence. The taxpayer is not entitled to a Schedule E deduction for any expenses associated with the rental of the property, and any income received from the rental use is not taxable [IRC Sec. 280A(g)]. Interest expense, to the extent it is qualified residential interest expense and real estate taxes are 100% deductible as itemized expenses on Schedule A. Effectively, the taxpayer is considered to have received tax-exempt, non-reportable income. This rule applies whether the property is the taxpayer's primary residence or any other residence

## Vacation Home with Both Rental and Personal Use

If property used as a residence is rented more than 14 days, deductions (other than interest, taxes, and casualty losses) are limited to the amount of the income from the property [IRC Sec. 280A(c)(5)]. A set of ordering rules applies in determining allowable deductions [Prop. Reg. 1.280A-3(d)(3)]. If these ordering rules apply, the passive loss limitations are not applicable [IRC Sec. 469(j)(10)]. **When determining the number of days a dwelling unit is used for personal purposes, a taxpayer must consider the following rules in addition to days of actual personal use:**

1. Personal use includes days the residence is used or rented to anyone at less than a fair rental [IRC Sec. 280A(d)(2)(C)].
2. Personal use by other owners (or members of their family) of the property is attributed to the taxpayer [IRC Sec. 280A(d)(2)(A)].
3. Rental to a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent) is considered personal use unless the taxpayer can establish that (a) a fair market rental rate was received and (b) the dwelling was used as the family member's principal residence [IRC Sec. 280A(d)(3)].
4. If the dwelling is used under a reciprocal arrangement that allows the taxpayer to use another dwelling, the days the taxpayer rents out his own unit are counted as personal days, even if he pays rent for the use of the other dwelling [IRC Sec. 280A(d)(2)(B)].
5. Days a taxpayer spends repairing and maintaining property on a substantially full-time basis, as well as travel days (the day arriving or leaving the property) when the primary purpose of the trip is to repair and maintain the property, are not counted as days of personal use. Substantially full-time (determined on a daily basis) means work is done on the unit for the lesser of eight hours or two-thirds of the time the individual is present on the premises. Provided all individuals on the property who are capable of working do work on the unit on a substantially full-time basis, use by other individuals or family members (e.g., children) not capable of such work is disregarded during a period of repair and maintenance.

## Rental Income and Expenses

Income and expenses from vacation homes are reported on Schedule E. Rental expenses are deductible in the following order [Prop. Regs. 1.280A-3(d)(2) and (3)]:

1. Qualified residential interest, taxes, casualty losses, and rental expenses not attributable to operating or maintaining the dwelling (e.g., expenditures to obtain tenants, such as commissions and advertising).
2. Operating expenses (including nonqualified residential interest), except depreciation.
3. Depreciation and other basis adjustments.

When applying these rules, the expenses in the second and third categories cannot produce a taxable loss. Thus, if the deductible interest and taxes completely offset the rental income, the operating expenses and depreciation are not deductible. Any expenses limited under this net income rule are eligible for carryforward to future years, but they remain subject to the net income limitation.

Periods of Vacancy. Many properties with mixed personal and rental usage have periods when the dwelling is vacant. In this circumstance, a controversy exists between the IRS and the courts as to how expenses are to be prorated. The IRS position [set out in Prop. Reg. 1.280A-3(c)] is that *all* expenses are to be prorated based on the period of actual usage (i.e., occupancy); whereas the courts have allowed taxpayers to prorate expenses attributable to the entire year (e.g., taxes and interest) over the full 365 days, since they accrue ratably throughout the year. The IRS position results in a greater allocation of interest and taxes to rental use, which reduces the taxpayer's deduction for operating expenses.

## Rental Property with Very Limited Personal Use

If the taxpayer's dwelling is rented during the tax year and personal use does not exceed the greater of (1) 14 days, or (2) 10% of rental days, it is not considered a residence. Instead, it is considered a rental property. Accordingly, no ordering tiers exist for claiming deductions, and the rental expenses are not limited to the gross rental income of the property. However, deductions must be allocated to the period of personal use, and the property is potentially subject to the hobby loss, passive activity loss, and at-risk limitations. Furthermore, the Schedule A mortgage interest deduction is lost (for the nonrental portion) because the property does not qualify as a residence.

**Caution:** If the taxpayer actively participates in the rental activity, a net loss otherwise subject to the passive loss rules is potentially deductible under the special \$25,000 rental real estate loss allowance. However, if the average period of customer rental is seven days or less, the activity is treated as a trade or business and not a rental activity for purposes of the passive activity rules [Temp. Reg. 1.469-1T(e)(3)(ii)(A)]. Thus, there is no \$25,000 rental real estate allowance. Taxpayers with rental properties in resort areas are particularly susceptible to this exception.