2024 TAXACT PROFESSIONAL EDUCATION FORUM

Schedule E for Residential Real Estate Activities

Presented By: Amy M. Wall

Rentals Got Complicated!

What We'll Talk About Today…

- By the end of our time together, you'll be able to:
  - Describe tax-free, short-term rentals.
  - Become familiar with unusual rental situations.
  - Calculate personal use days.
  - Identify and allocate short-term rental deductions.
  - Know how and when to take losses.
  - Summarize IRS reporting for short-term rentals.

Section 1

Tax-Free Rentals

When is Rental Income Tax-Free?

"… If a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, then… the income derived from such use for the taxable year shall not be included in gross income…" §280A(g)

AKA Master's Exception / Augusta Exception

Taxpayer’s Residence

- What does “taxpayer uses it as a residence” mean?
  - The residence qualifies if the taxpayer uses the dwelling for at least 14 days during the year **or** more than 10% of the number of days during the year the property was rented at FRV.
  - Note that personal use includes any day that is classified as a personal day.
- So, the Augusta Rule IRS exemption can apply to *any* residence meeting this requirement.
- No deductions allowed against tax-free income, but mortgage interest and real estate tax may be deducted in full on Schedule A.

What Does a "Day" Mean?

- A "day" is a 24-hour period for which a day's rental would be paid, not necessarily a calendar day.
  - A guest who rents for a week, Saturday afternoon to Saturday afternoon, is treated as having used the home for 7 days, even though the tenant was on premises for 8 different days
  - Tenants paying less than FRV still count as it being rented!
    - *If the host is being paid, then it's rented.*
    - *If the host is not being paid, then it's not rented.*

14-Day Rule for a Room

The same treatment applies for a room in taxpayer’s home.

Ex: Constance rents out a room in her principal residence for 14 days (she pays no tax on that income).

The following year, she rents it for out for 15 days. Now **all** that rental income is subject to tax!

Timeshares

- If I rent out my timeshare for 14 days or less, do I have to pay tax on it?
  - Maybe!
- If you use your timeshare for at least 15 days personally **in addition** to the rental period, then it becomes a vacation home, and you qualify for the Masters deduction.
  - If not… no.

So, If the Taxpayer Doesn't Use It…

- Carl owns a home with a separate casita in the back yard.
- The casita is a stand-alone unit, with a kitchen, bedroom and bathroom.
- Carl doesn't spend time in the casita other than to maintain it.
- Carl rents it out for 10 days.
- Because there is no personal use, that rent is taxable income.

If the Taxpayer DOES Use It…

- Susan owns an apartment in LA and a vacation home on Cape Cod.
- She spends 8 months out of the year in LA and 4 months at the Cape.
- She rents out her LA apartment for 10 days and the vacation home for 14 days.

Will she pay tax on any of that income?

Watch for These States

- Five states do not follow the federal rule on not imposing income tax on rentals of less than 14 days:
  - Alabama
  - Arkansas
  - Mississippi
  - New Jersey
  - Pennsylvania

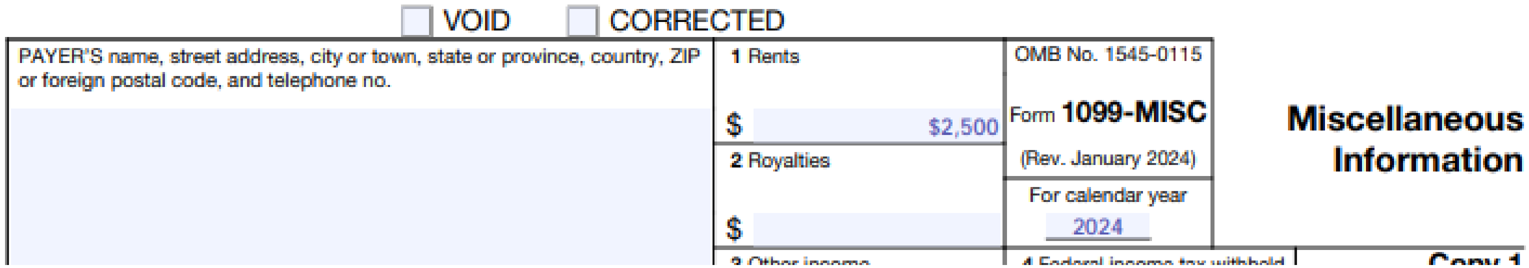
Deductions on Tax-Free Income

- No deductions are allowed on tax-free income. (You'd hope that would be obvious.)
- Airbnb fees, cleaning, supplies, repairs, insurance, depreciation, etc., do not qualify as deductions.
- Mortgage interest and real estate taxes may be deducted on Schedule A, no allocation required for those 14 days.

1099 Received!

- Carla rented her principal residence on the beach to a small company for them to have an offsite meeting (they paid her $2,500).
  - *She stayed in a hotel during that time.*
- Rental period was 4 days and you assured her that she would pay no tax on the money.
- She comes in waving a 1099 in your face showing $2,500 in Box 1, rents!

What will you do?


VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1 Rents $ $2,500

2 Royalties $

OMB No. 1545-0115

Form 1099-MISC (Rev. January 2024)

For calendar year 2024

Miscellaneous Information

Section 2

Income and Expenses

What Counts as Income?

- Rental income paid by tenants or guests.
- Nonrefundable security deposits when paid.
- Refundable security deposits in the year the money is retained.
- Property/services in lieu of rent.
- Rental expenses paid for by guests.
- Reservation cancellation fees retained by landlord.
- Other fees paid by guests.
  - *Garage or parking fees, storage facility fees, pet fees, laundry income from coin-operated machines, etc.*

What Counts as an Expense?

- Expenses fall into these categories:
  - Operating Expenses
  - Repairs and Maintenance
  - Long-Term Assets
  - Pro-Rated Deductions

Section 3

Operating Expenses

Operating Expenses

- Taxpayers can deduct in any given year any expense that is:
  - Ordinary and necessary: common, helpful, appropriate for the rental activity.
  - Current: Will benefit the rental for less than one year.
  - Directly related to rental activity: not personal; mixed-use expenses must be prorated between personal and rental.
  - Reasonable in amount: the most economical and practical way to achieve the result.

Direct Expenses

- Rental platform fees and commissions: typically, 3% for hosts.
- Hosts may deduct whatever fees and commissions they pay.
- Guests also pay fees, but the host cannot deduct those (obviously).
- Expect Airbnb, Venmo, etc., to request a W-9 to verify the taxpayer’s identity.
- Ask the taxpayer to bring in any 1099s received from the platform.

Marketing Expenses

- May include payments made to a professional photographer, copywriter who writes your ads, website hosting and SEO campaign payments.
- Cost of initially developing a website for the rental may have to be amortized over 3 years as software.
- Once in place, updating the website would be a deductible expense.

Local Transportation

- Local travel is defined as by car, or similar means, within the area of your tax home.
- If rental is in same city as taxpayer’s residence, this may be a fairly small deduction.
- Local travel for picking up supplies or repair materials is also deductible.
- Driving to and from the airport to pick up guests is deductible.
- Typically hosts use a standard mileage rate.

Long Distance Transportation

- Defined as travel away from tax home requiring an overnight stay at the destination prior to returning home.
- To be deductible, the travel must be primarily in service of the rental activity, meaning that the taxpayer spends over half his time working at rental purposes while away.
  - Traveling to the property to deal with guests, maintenance, repairs.
  - Traveling to building supply stores, etc., to obtain materials and supplies.
  - Leaning new skills such as landlord-related classes, seminars, etc.
  - Meeting attorneys, accountants, real estate managers, etc.

Travel Deductions

- Travel to improve the property such as putting on a new roof is not deductible!
- The cost of the travel is added to the basis of the improvement.

Home Office?

- Yes, it’s possible for a short-term rental landlord to have a home office.
- All the usual requirements such as regular and exclusive use are in place.
- Actual or simplified methods are both available.

Home Office?

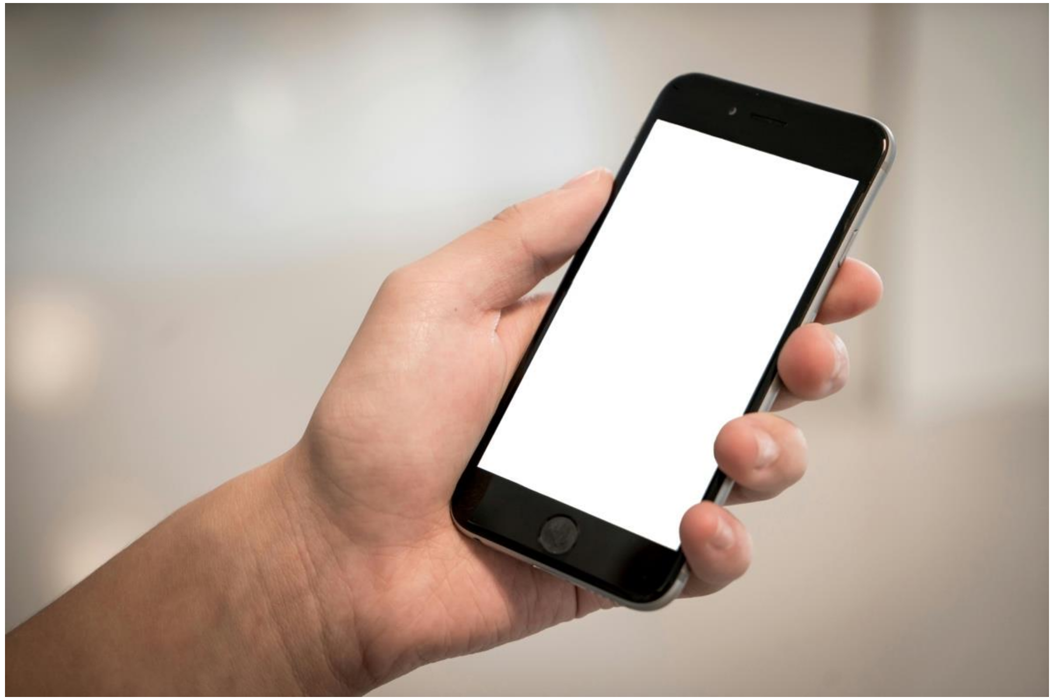
- Be careful! Managing an Airbnb might require a home office; managing a regular rental (with a lease) is unlikely to qualify.
- **Edwin R. Curphey, 73 T.C. 766 (1980)**
  - Taxpayer managed SIX rental properties from his home office which was used regularly and exclusively to manage rental basis.
  - Transportation between the home office and rental properties were pronounced deductible as ordinary and necessary business expenses.
- Curphey was a dermatologist at a hospital but that did not make him ineligible for the home office deduction.

Guest Amenity Deductions

- Guest amenities such as linens, soaps, shampoo, toothpaste, toothbrushes, razors, toilet paper, paper towels, and the like are fully deductible if purchased for guests.
- If hosts also use these items, proration is required.

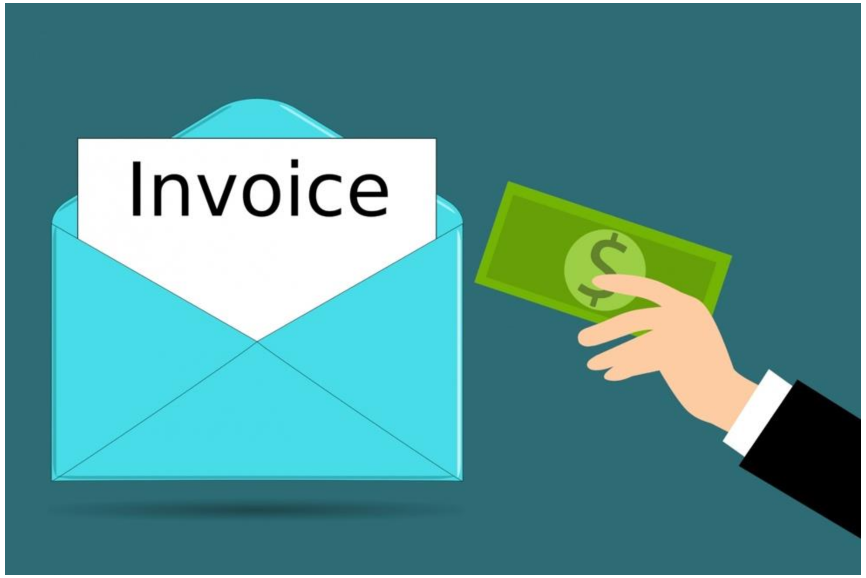
Phone Line Deductions

- Cost of main phone line from taxpayer's own home is not deductible
  - Second line for rental purposes only is deductible
- Portion of cell phone used for business may be deducted



Legal and Professional Fees

- Legal and professional fees paid to attorneys, accountants, someone to process sales tax forms, etc.
- Preparation of forms related to the rental are deductible, but payments made for the personal portion of tax return are not deductible.



Entertainment

- Entertainment for guests is not deductible!
  - Theater tickets? No.
  - Baseball tickets? No.
  - Movie tickets? No.
- But, providing games and DVDs for in-rental use are deductible expenses.

Materials & Supplies

- Materials and supplies are tangible property used/consumed in rental activity that is any of the following:
  - Cost $200 or less.
  - Economic useful life of 12 months or less.
  - Components acquired to maintain/repair property.
- The cost of these materials and supplies is deducted in the year the item is used or consumed (which may well be later than the year of purchase).
- It is impractical for landlords to track this, so using the *de minimis* safe harbor is advised.

Other Operating Expenses

- Fees and service charges made to online payments services.
- Cost of a lockbox and/or keys.
- Cost of storing host’s belongings while guests are in residence.
- Cost of credit reports obtained to screen guests.
- Dues and Subscriptions
- Education related to rental activity.

Which of the following are fully deductible by the host in the year of the expense?

a. Amenities used only by guests.
b. Home Phone Line
c. Transportation to the rental to put on a new roof.
d. Fees paid by the host to the rental agency.
e. Fees paid by the guest to the rental agency.

Section 4

Repairs and Maintenance

Repairs vs. Improvements

- Repair expenses are deductible in the year paid.
- Improvement expenses are capitalized and depreciated.
- The difference between the two has been hotly debated by business owners and the IRS… resulting in a very long set of “repair regulations” released in 2014.

Generally Speaking…

- Maintenance is undertaken to *prevent* something from breaking.
- Repairs are undertaken *after* something has already broken.
- Improvements are undertaken to do one of the following:
  - **B**etter the Property
  - **A**dapt the property to a new use.
  - **R**estore the Property
- Just remember that improvements raise the **BAR!**

Safe Harbors

- There are 3 important safe harbors:
  - Safe Harbor for Small Taxpayers
  - Routine Maintenance Safe Harbor
  - De Minimis Safe Harbor

Safe Harbor for Small Taxpayers

Per Reg. §1.263(a)-3(h), a qualifying small taxpayer may elect to not apply improvement rules to an eligible building if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the building does not exceed the lesser of:

$10,000 or 2% of the **unadjusted** basis of the building.

Pay attention to the annual expense limitation!

Safe Harbor for Small Taxpayers

- A qualifying small taxpayer is one whose average annual gross receipts for the three preceding taxable years are $10 million or less.
- An eligible building is one that is owned or leased by the qualifying small taxpayer if the **unadjusted** basis of the building property is $1 million or less.
- If the small taxpayer safe harbor is applicable and elected, a qualifying taxpayer is not required to apply the improvement standards to owned or leased eligible buildings.

Safe Harbor for Small Taxpayers

Once the annual election is made, it may not be revoked for that year.

Section 1.263(a) – 3(h) Safe Harbor Election for Small Taxpayers

Taxpayer's name: ______________________________

Taxpayer's address: ____________________________

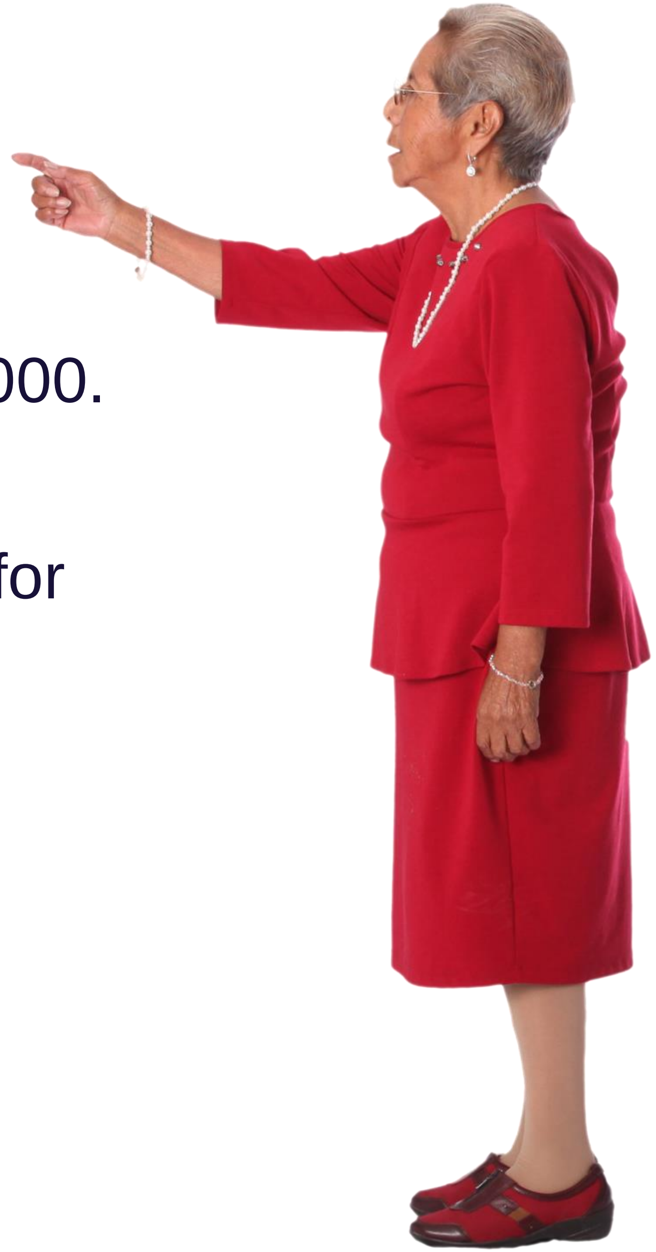
Taxpayer's identification #: _______________________

The taxpayer is hereby making the safe harbor election for small taxpayers under Section 1.263(a)-3(h) for the following property:

(*describe*)

Example: Patricia

- Patricia owns a townhouse that she rents out part-time.
- Its unadjusted basis is $150,000. 2% of that basis is $3,000.
- She may use this safe harbor only if all repairs, improvements, maintenance, etc., total less that $3,000 for the year.
- Which means you would not have to tease out what she spent on improvements vs. repairs, just deduct the full amount.



Routine Maintenance Safe Harbor

- Routine maintenance safe harbor is codified in §1.263(a)-3(i).
- It allows a building owner to expense repairs that they determine will be repeated at least every 10 years.
- Multifamily residences and hotels, for example, routinely repaint, update lighting fixtures and plumbing fixtures, change worn carpet, etc.
- These items can be costly to replace for the owners, but by utilizing the Routine Maintenance Safe Harbor, these expenditures can be expensed rather than capitalized over 27.5 or 39 years.

Routine Maintenance Safe Harbor

- There are no annual dollar limits to qualify for this safe harbor.
- This does not apply to expenditures that make a component better or expands the size of the building.
- The expenditure is deductible if the taxpayer reasonably expects to perform the same repair again in the next 10 years.
- Once adopted, this method of accounting must be used every year.
- **Note: It is a method of accounting, not an election!**

De Minimis Safe Harbor

- §1.263(a)-1(f) allows taxpayers to expense items that cost under $2,500 per invoice or per item.
- This is simply an administrative convenience to avoid having to depreciate small-dollar items.

De Minimis Safe Harbor

Section 1.263(a) – 1(f) De Minimis Safe Harbor Election

Taxpayer's name: ______________________________

Taxpayer's address: ______________________________

Taxpayer's identification #: ______________________________

The taxpayer is hereby making the de minimis safe harbor election under Section 1.263(a)-1(f) for the following property:

(describe)

Which is an accounting method, rather than an election?

a. De minimis Safe Harbor
b. Routine Maintenance Safe Harbor
c. Safe Harbor for Small Taxpayers

Section 5

Long-Term Assets

Long-Term Assets

- Assets that have a useful life of more than one year may be depreciated over time rather than deducted in the year the cost is incurred.
- When property is sold, basis is adjusted by depreciation that was taken or should have been taken.
- If depreciation was not taken correctly, then we can use Form 3115 to correct depreciation errors.

Long-Term Assets

- Residential rental buildings and structural components such as roofs are depreciated over 27.5 years, straight line, mid-month.
- Commercial buildings are depreciated over 39 years.
- Appliances, floor coverings, furniture are depreciated over 5 years.
- Fences and shrubbery are depreciated over 15 years.
- When the residence is first placed in service, all its components are included in the 27.5 years.
- Property placed in service afterwards is depreciated separately.

Example: John

- John purchased a condo to rent out and placed it in service 1/1/2015.
- Depreciation starts that date, SL, 27.5 years even though it has draperies, flooring and appliances inside it.
  - Alternately, John can pay for a cost segregation study separating out the disparate elements of the condo to be depreciated separately.
- On 1/1/2019, he purchased a new dishwasher. This will be depreciated independently over 5 years, starting with the in-service date.

Is a Short-Term Rental Commercial Property?

- Residential rental property includes buildings for which 80% or more of the gross rental income is rental income from **dwelling unit.**

- A dwelling unit is a house or apartment used to provide living accommodations in a building or other structure.

- A dwelling unit **does not include** a unit in a hotel, motel or other establishment in which more than 50% of the units are used on a **transient** basis.

- While the IRS does not clearly define **transient**, it often uses a lease term of 30 days or less. This is based on the definition under the old Section 48 and is backed by the IRS in a Private Letter Ruling (PLR-139827-07).

Bonus Depreciation

- Bonus depreciation can be used to deduct the cost of any asset with a class life of less than 20 years:
  - ~~2022 - 100%~~
  - ~~2023 - 80%~~
  - 2024 - 60%
  - 2025 - 40%
  - 2026 - 20%
  - 2027 - 0%
- 15-Year Land Improvements Qualify
  - Excavating, grading, landscaping, fences, swimming pools, sprinkler systems.

Electing Out of Bonus Depreciation

- Bonus depreciation must be elected **out of**, not **into**.
- To elect out:

Bonus Depreciation Opt Out

Taxpayer's name: ______________________________

Taxpayer's address: ____________________________

Taxpayer's identification #: ______________________

The taxpayer is hereby electing out of bonus depreciation for the following class(es) of property:

(describe: 5 yr, 7 yr, etc.)

Section 179

- §179 is a special type of depreciation that allows business owners to depreciate 100% of the property in the year in which it is placed in service, but cannot create or increase a business loss.
- In addition, there is a limit of $1.22M for 2024.
- Any property that is used **personally** 50% or more of the time is not eligible for §179.
- If property was §179'd and business use falls below 50% in a later year, the excess depreciation must be recaptured in that year.

Section 179

- It can be used for any sort of personal property, including roofs, heating, ventilation, air conditioners, fire alarms, security systems.
- It cannot be used for land, land improvements, buildings, swimming pools, fences, paved parking areas or property outside the U.S.
- Unlike bonus depreciation, it is not necessary to apply it class-wide or even to all of a single asset!
- The election to use §179 is made by taking the depreciation on Form 4562.

Watch the States!

- Many states have decoupled from federal depreciation rules such as bonus depreciation and §179.
- Some states decoupled from bonus, others from §179, some from both.
- Among the states that have decoupled in one way or another: Arkansas, Arizona, California, Connecticut, DC, Georgia, Hawaii, Iowa, Idaho, Illinois, Indiana, Kentucky, Massachusetts, Maryland, Maine, Michigan, Minnesota, Mississippi, North Carolina, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, South Carolina, Tennessee, Virginia, Vermont, Wisconsin

Pro-Rating Depreciation

- When calculating depreciation on short-term rentals, take the full 100% depreciation, multiply this by the amount of square footage (if less than the entire house is being rented out) and multiply that result by the portion of the year that the house is rented.

Example: Linda

- Example: Linda’s home has a $100,000 basis and is being depreciated over 27.5 years.
- This year she rented it out for 3 months:
  - Her depreciation deduction for the year is $100,000 ÷ 27.5 x 3/12 = $909.

Example: Louise

- Louise’s home has a $100,000 basis and is being depreciated over 27.5 years.
- This year she rented out 20% of the house for 3 months.
    - Her depreciation deduction for the year is $100,000 ÷ 27.5 x 3/12 x 20% = $182.

Personal Property Also Long-Term Assets

- Personal property is any long-term asset that isn't real property.
  - It is not part of the building structure itself, a structural component, or a land improvement.
  - It is moveable, typically of lower expense and not as long-lasting.
  - Furniture, appliances, window coverings, plants, movable partitions, portable ACs and heater, televisions, other entertainment systems.
- Personal property may also include items the taxpayer uses in rental activity, but isn't used by guests.
  - Lawn mowers, office equipment, etc.

Personal Property in Common Areas

- Personal property in common areas used by both the host and the guests not deductible.
- **Example:**
  - If a bedroom is rented to short-term guests, the cost of the bedroom furniture is a deductible expense.
  - The cost of a dining room table used by the host and the guests is not a deductible expense, nor may it be pro-rated.

Section 6

Schedule C?

Services

- Ordinary Services: Heat, Cooling, Water, Electricity, Trash Collection
- Significant Services: Regular Cleaning, Changing Linen, Maid Service, Valet Service, Concierge Services, Meals Provided
- Extraordinary Services with No Separate Charge: Maid services, instruction in swimming/boating/fishing, conducting fishing parties, delivering messages and mail, furnishing bus schedules, church information and other services deemed necessary for the convenience of guests.

Chief Counsel Memorandum 202151005

- Taxpayer A rents out a fully furnished vacation property via an online rental marketplace.
- Taxpayer A provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, the taxpayer provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district.
- Average stay is 7 days!

Chief Counsel Memorandum 202151005

- Taxpayer B rents out a fully furnished room and bathroom in a dwelling via an online rental marketplace.
- Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay.
- Average stay is 7 days!

Chief Counsel Memorandum 202151005

- Conclusion: The net rental income in Fact Situation 1 [Taxpayer A] is **not** excluded from NESE under § 1402(a)(1) because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy.
- The net rental income from Fact Situation 2 [Taxpayer B] **is** excluded from NESE under § 1402(a)(1) because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy.
- So even though average rental period in both cases was 7 days, the conclusion turned on the issue of services provided.

26 CFR § 1.469-1T - General Rules (Temporary)

- **EXAMPLE 4:** The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days.
- In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property.
- The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments.
- Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. **Accordingly, the activity is a rental activity.**

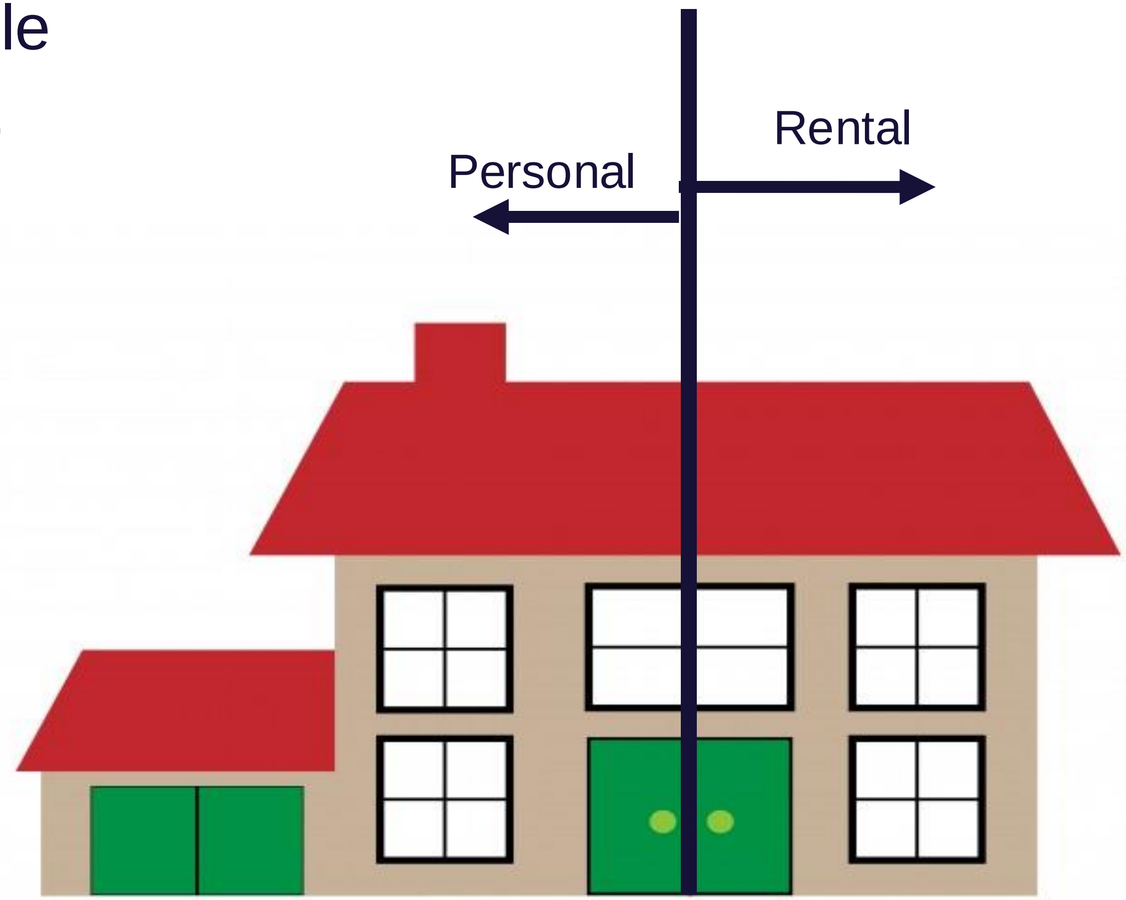
Seems Pretty Arbitrary….

Section 7

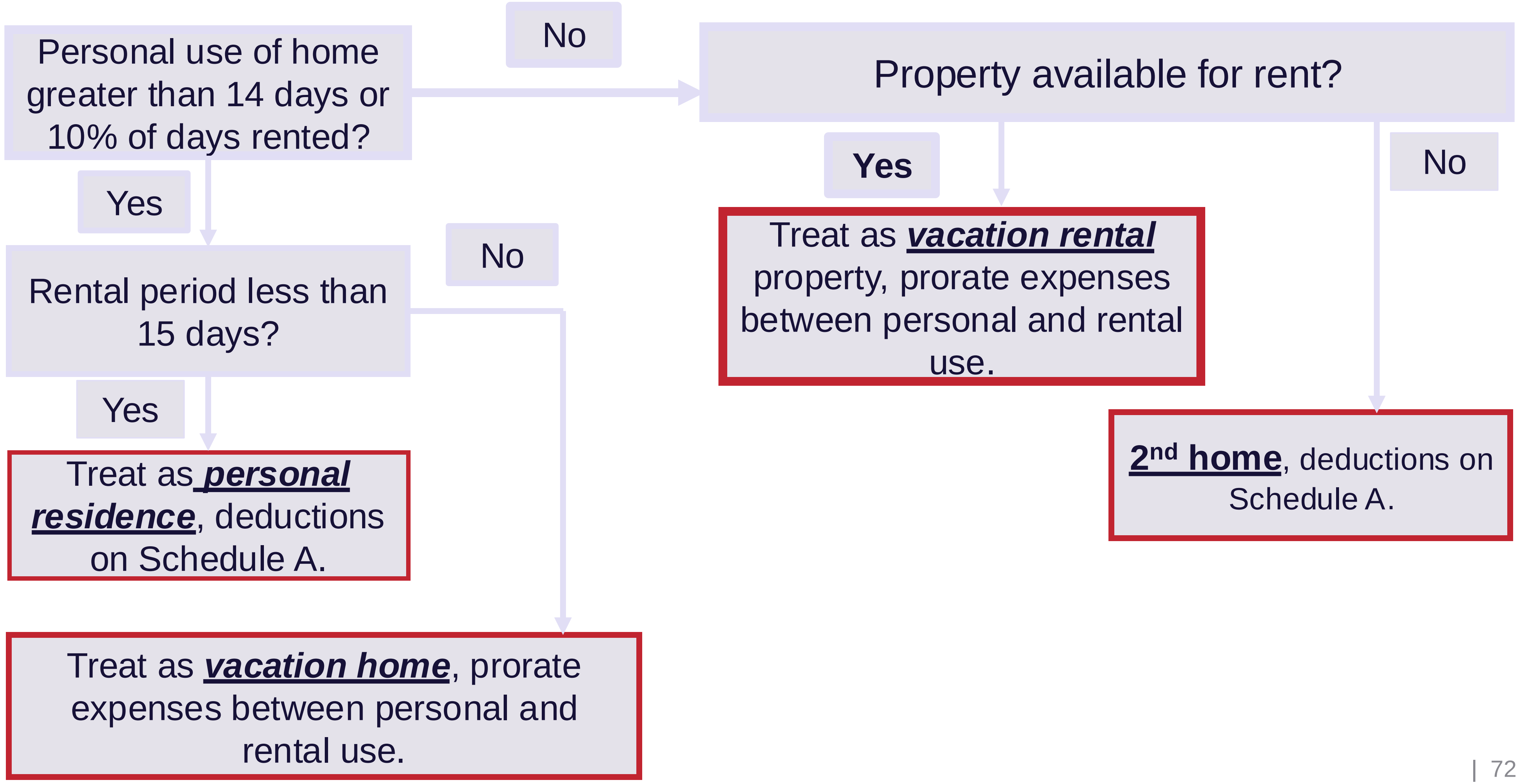
Dual Use Property

Reporting Dual Use Properties

- When a property is dual-use, deductions are generally allocated between Schedule A (personal deductions) and Schedule E (rental deductions).
- Details vary depending on the situation and the number of personal use days!

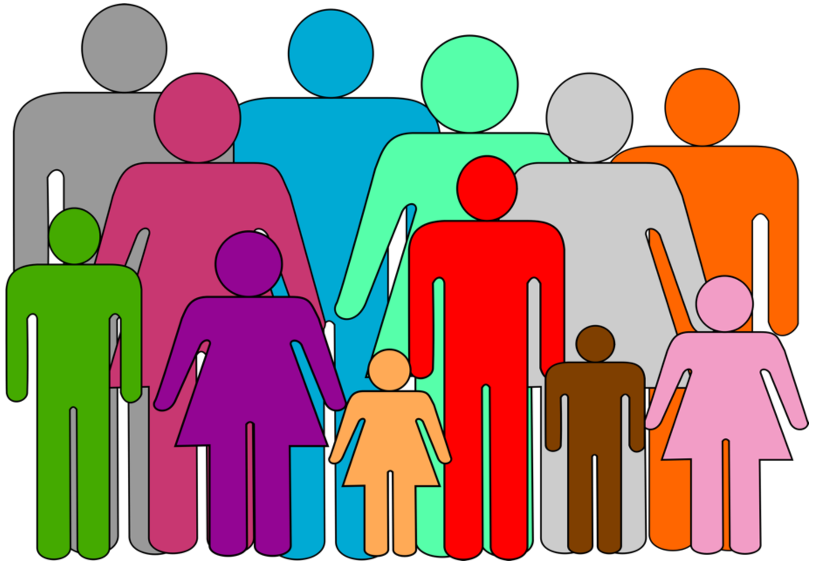


Reporting Dual Use Properties



What are Personal Use Days?

- When an owner uses the property, it's a personal use day.
- When a family member of the owner uses the property, even if fair market value is paid for the time, it's a personal use day for the owner.

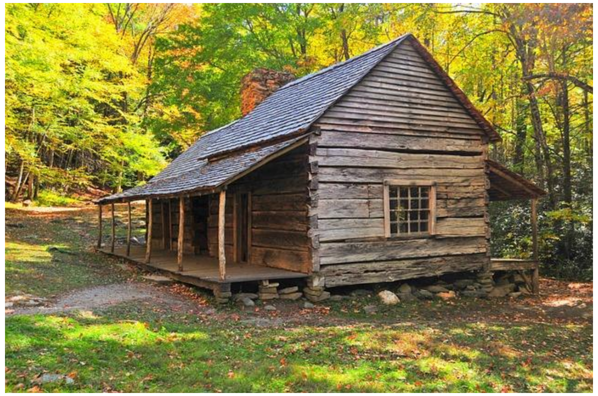


Two Exceptions!

- **Exception #1:** if the family member uses the property as his primary residence, pays FMV and has no ownership interest, then this is not a personal use day for the owner.
- **Exception #2:** Any day that you spend working substantially full time repairing and maintaining (not improving) your property is **not** a personal use day, even if family members use the property for recreational purposes on the same day.

Personal Use Days Example

- John owns a mountain cabin. His son, Paul, stays there for six months and pays fair market rent of $1,000 per month.
- If this is Paul's principal residence for those six months, then the six months do **not** count as personal use days for John.
- But if this is not Paul's principal residence and he's just hanging out there while writing his novel, these six months count as personal use days for John.



Personal Use Days Example

- Jane owns a beach house!
- Jane rents it to her mother for a month at a reduced rate.

Personal use days for Jane?

Personal Use Days Example

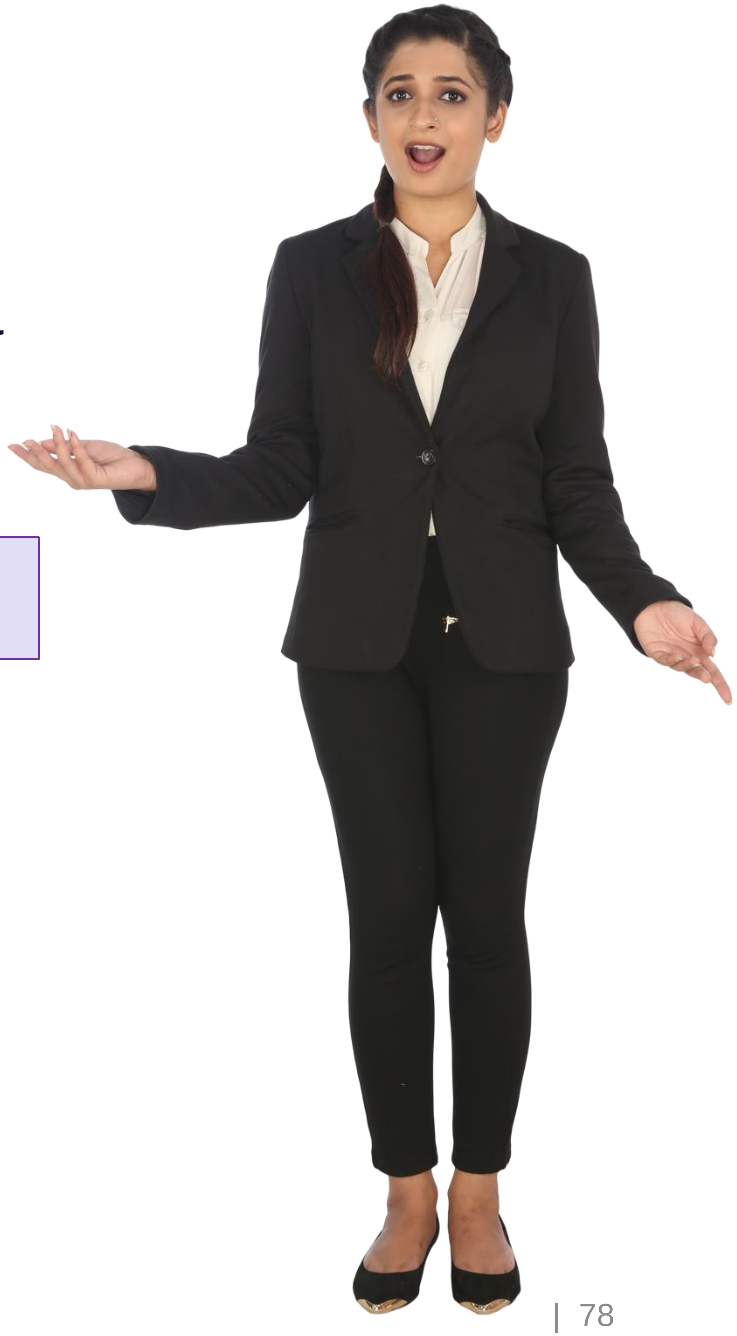
- Jane owns a beach house!
- Jane rents it to her mother for a month at a fair market rent.

Personal use days for Jane?

Personal Use Days Example

- Jane trades a month at her beach house for a month at a house in Australia.

Personal use days for Jane?



Which are personal use days?

a. Bob rented his lakeside cabin to a friend in exchange for however many fish the friend caught during his stay.
b. Charlie rented his condo in Florida to his mom for a week at fair rental value.
c. Donna traded a month at her Las Vegas condo for a month in a London flat.
d. Evan rented a house to his son at fair market rent; the son used the house as a principal residence.
e. Frank spent a week painting his beach house.

Section 8

Deducting Losses

Losses

- When expenses exceed income, it may not be deductible if there is owner use of the property.
- Different rules for different situations!
  - Business AKA Schedule C Rules
  - Vacation **Rental** Rules
  - Vacation **Home** Rules

Schedule C Losses Require Material Participation

- Losses may be deducted from other (nonrental) income if the host materially participates in the activity. The IRS has created 7 tests to determine material participation. Most common for this situation:
  - 500-hour test: taxpayer has participated in the activity for more than 500 hours.
  - Substantially All Test: Taxpayer did substantially all the work in the activity during the year.
  - 101-Hour Test: Taxpayer participated in the business for more than 100 hours during the year and at least as much as any other person.
  - Note that spouse’s hours count (but not children’s).

Vacation Rental Activity Rules

- Vacation rentals use the regular rental activity rules!
  - Taxpayer rented the property for MORE than 14 days and used it personally for 14 days or LESS or no more than 10% of the rental days.
  - The activity does not qualify as a hotel business, meaning average stay is either more than 30 days or is 8-10 days with no significant services and apparently can even be 7 days with no significant services.
- The passive activity loss rules apply.

Vacation Rental Activity Losses

- §469(i) allows for a loss of up to $25,000 most people ($12,500 MFS) if the taxpayers actively participate in rental real estate activity and other qualifications are met.
  - Taxpayer must own at least 10% of the property.
  - Taxpayer cannot be a limited partner, unless he is also a general partner eligible for the loss.
  - Losses cannot be from an irrevocable trust that made a §645 election and cannot be from a net lease activity.
  - Taxpayers must make management decisions in a significant and bona fide sense.
- Phaseout begins at MAGI $100K ($50K MFS) and is fully phased out when MAGI is $150K ($75K MFS).

Vacation Rental Activity Losses

- If taxpayer has more than $25,000 in losses or doesn't qualify due to MAGI, the losses are carried forward until they can be used.
- Ultimately, these losses can be taken upon sale of property, reducing or even eliminating taxable gain.

Vacation Home Rules aka Worst Scenario

- Rental losses are subject to vacation home rules if the taxpayer rents all or part of a property for more than 14 days during the year…
- AND personal use days number more the greater of 14 days or 10% of the number of days the property is rented at FRV.
- In this situation, deductions are limited to income! No losses may be taken.
- Expenses taken in a certain order; unused expenses carry forward to the following year.

Section 9

Pro-Rating Expenses

Pro-rating Expenses

- If the host doesn’t rent out 100% of the property 100% of the time, expenses must be prorated between:
  - Property Rented vs. Property Used Personally
  - Amount of time in the year the property is rented.
- Prorate: Depreciation, mortgage interest and property taxes, rent if the taxpayer himself is a tenant of the property, repairs, maintenance, cleaning, trash removal, condo/HOA fees, utilities, internet, insurance.

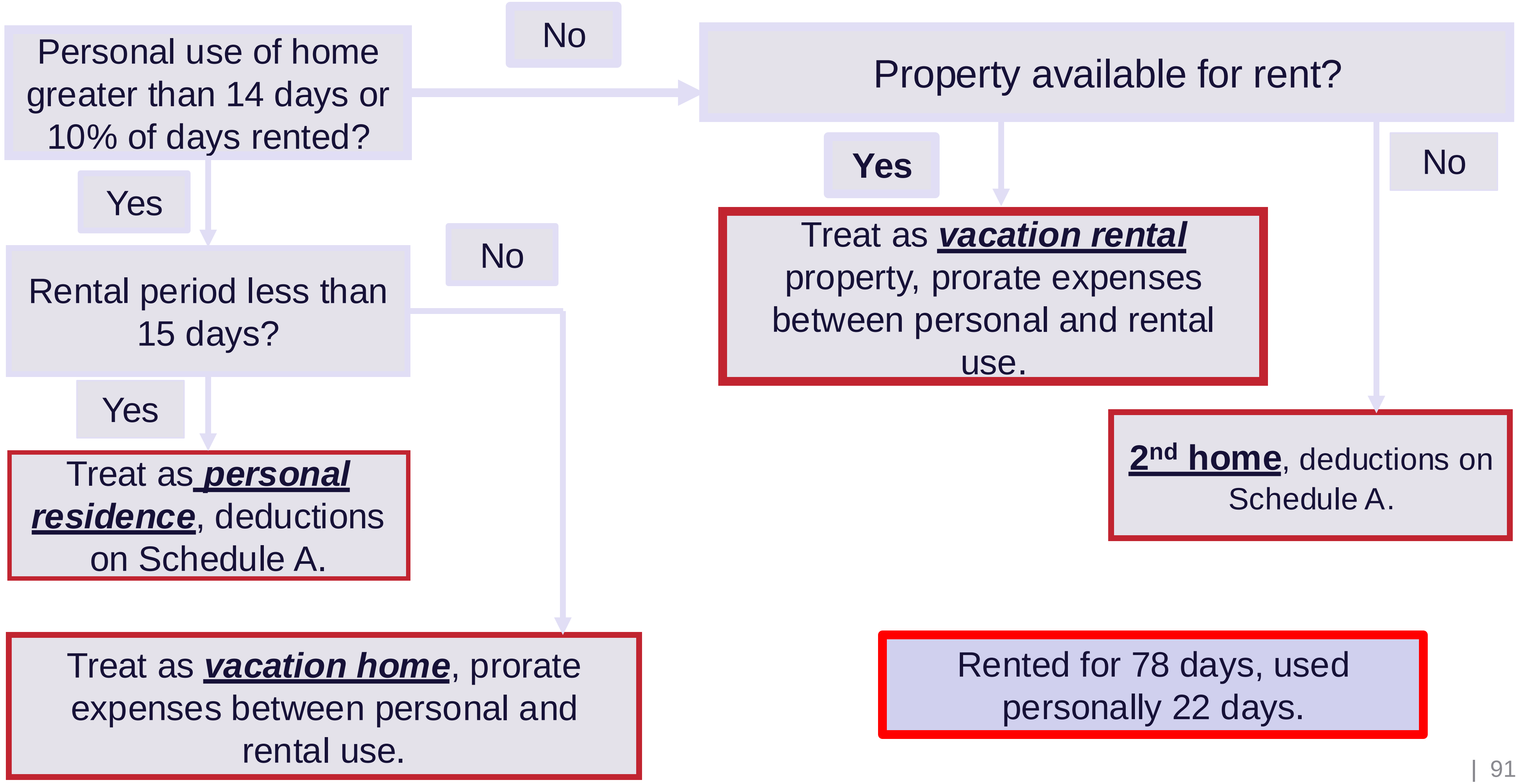
Renting Out Entire Property

- If the taxpayer rents an entire property to short-term guests, the expenses are allocated based on the number of days the property was rented out over the tax year over a denominator.
- The denominator depends on whether the calculation is using the “IRS Method” or the “Tax Court Method” aka “Bolton Method.”
- The IRS method uses the total number of days used (rental use + personal use) while the Tax Court method uses 365 days as the denominator.

Prorating Expenses

- Jane's beach house was used a total of 100 days during the year.
- It was rented at FRV for 78 days and she used it personally 22 days.
    - It was vacant the remaining 265 days.
- Her Expenses:
    - Mortgage Interest - $12,200
    - Real Estate Taxes - $3,700
    - Repairs and Maintenance - $6,200
    - Depreciation - $5,500

Reporting Dual Use Properties



What Do I Do About Vacant Days?

- Good question!
- IRS Position: Expenses are prorated based on period of actual use throughout the year.
- Tax Court Position: Mortgage interest and real estate tax are prorated based on 365 days.
    - *Other deductions follow the IRS position.*

Jane’s Deductions: Tax Court vs IRS

- Using IRS Position:
  - 78 ÷ 100 = 78% Rented
  - 78% Interest = $9,516
  - 78% Taxes = $2,886
  - 78% Repairs = $4,836
  - 78% Depreciation = $4,290
  - Total: $21,528 (But not really because expenses are limited to income for vacation home!)

Mortgage Interest - $12,200
Real Estate Taxes - $3,700
Repairs - $6,200
Depreciation - $5,500

- Using the IRS Method, mortgage interest on Schedule A is only $12,200 - $9,516 = $2,684.
- Taxes on Schedule A is only $3,700 - $2,886 = $814.

Jane’s Deductions: Tax Court vs. IRS

- Using Tax Court Position:
  - 78 ÷ 365 = 21% Rented
  - 21% Interest = $2,562
  - 21% Taxes = $777
  - 78% Repairs = $4,836
  - 78% Depreciation = $4,290
  - Total: $12,465

Mortgage Interest - $12,200
Real Estate Taxes - $3,700
Repairs - $6,200
Depreciation - $5,500

- Using the Tax Court Method, mortgage interest on Schedule A is $12,200 - $2,562 = $9,638.
- Taxes on Schedule A is $3,700 - $777 = $2,923.

Jane’s Deductions

- Using IRS position:
  - 78 ÷ 100 = 78% rented
  - 78% interest = $9,516
  - 78% taxes = $2,886
  - 78% repairs = $4,836
  - 78% depreciation = $4,290
  - Total $21,528 (but not really because expenses are limited to income!)

- Using Tax Court position:
  - 78 ÷ 365 = 21% rented
  - 21% interest = $2,562
  - 21% taxes = $777
  - 78% repairs = $4,836
  - 78% depreciation = $4,290
  - Total $12,465

Which is Better?

- Before the TCJA, it was fairly simple to determine which method was best for allocating expenses for personal/rental vacation homes.
- If taxpayers itemized deductions, the court method usually was more favorable. If they used the standard deduction, the IRS method was more favorable.
- Post TCJA, taxpayers will have to estimate the amount of real estate taxes and mortgage interest allowed and compare that to estimates of net rental income to determine the preferable method.

Disclose?

- The Tax Court position has been supported in the 9th Circuit Court of Appeals (Bolton) and the 10th Circuit Court of Appeals (McKinney).
- Practitioners in other jurisdictions using the Tax Court position should make sure clients understand that the IRS has not accepted this position.
- Note, though, that the IRS position is a proposed regulation, not a final or temporary regulation, so Form 8275-R (*Regulation Disclosure Statement*) is not required when using the Tax Court position.

Renting Out a Room

- Now the math gets a little more complicated!
- Divide the square footage of the room by the square footage of the house.
- Then multiply that number by the percentage of time the room was rented.

Renting Out a Room Example

- Ruth owns a two-bedroom townhouse in Manhattan which is her main residence.
- She rents one of the bedrooms occasionally through Airbnb.
- That one bedroom represents 20% of the square footage of the house.
- The room was rented out for 100 days.
- We do the math as follows: (100 ÷ 365) X 20% = 5%.
- Ruth can deduct 100% of her direct expenses and 5% of prorated expenses.

Section 10

Ordering Rules

Here's Jane Again

- Jane rented out her beach house at FRV for 78 days for $15,600.
- Personal use was 22 days.
- It was vacant for the remaining 265 days.
- Meets the definition of a vacation home!
- Expenses:
  - Mortgage Interest - $12,200
  - Real Estate Taxes - $3,700
  - Repairs - $6,200
  - Depreciation - $5,500

Ordering Rules for Deductions

- Since deductions are limited to income, there's a particular order in which they must be taken.
  - Mortgage Interest
  - Real Estate Taxes
  - Casualty Losses (Suspended Through 2025)
  - Direct expenses not related to operating and maintaining the property but related to the rental (agency fees, advertising, office supplies).
  - Expenses such as repairs, insurance, utilities.
  - Depreciation

IRS Worksheet 5-1

Worksheet 5-1. **Worksheet for Figuring Rental Deductions for a Dwelling Unit Used as a Home**

Keep for Your Records

Use this worksheet only if you answer "Yes" to all of the following questions.

- Did you use the dwelling unit as a home this year? (See Dwelling Unit Used as a Home.)
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

PART I. Rental Use Percentage

A.	Total days available for rent at fair rental price	**A.**		
B.	Total days available for rent (line A) but not rented	**B.**		
C.	**Total days of rental use.** Subtract line B from line A	**C.**		
D.	**Total days of personal use** (including days rented at less than fair rental price)	**D.**		
E.	**Total days of rental and personal use.** Add lines C and D	**E.**		
F.	**Percentage of expenses allowed for rental.** Divide line C by line E		**F.**	.

PART II. Allowable Rental Expenses

1.	Enter rents received		**1.**	
2a.	Enter the rental portion of deductible home mortgage interest. See instructions	**2a.**		
b.	Enter the rental portion of deductible real estate taxes. See instructions	**b.**		
c.	Enter the rental portion of deductible casualty and theft losses. See instructions	**c.**		
d.	Enter direct rental expenses. See instructions	**d.**		
e.	**Fully deductible rental expenses.** Add lines 2a–2d. Enter here and on the appropriate lines on Schedule E. See instructions		**2e.**	
3.	Subtract line 2e from line 1. If zero or less, enter -0-		**3.**	
4a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	**4a.**		
b.	Enter the rental portion of excess mortgage interest. See instructions	**b.**		
c.	Enter the rental portion of excess real estate taxes. See instructions	**c.**		
d.	Carryover of operating expenses from 2021 worksheet	**d.**		
e.	Add lines 4a–4d	**e.**		
f.	**Allowable expenses.** Enter the **smaller** of line 3 or line 4e. See instructions		**4f.**	
5.	Subtract line 4f from line 3. If zero or less, enter -0-		**5.**	
6a.	Enter the rental portion of excess casualty and theft losses. See instructions	**6a.**		
b.	Enter the rental portion of depreciation of the dwelling unit	**b.**		
c.	Carryover of excess casualty and theft losses and depreciation from 2021 worksheet	**c.**		
d.	Add lines 6a–6c	**d.**		
e.	**Allowable excess casualty and theft losses and depreciation.** Enter the **smaller** of line 5 or line 6d. See instructions		**6e.**	

PART III. Carryover of Unallowed Expenses to Next Year

7a.	**Operating expenses to be carried over to next year.** Subtract line 4f from line 4e		**7a.**	
b.	**Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6e from line 6d		**b.**	

IRS Worksheet 5-1 Part I

- Use this worksheet if you answer YES to the following:
- Did you use the dwelling unit as a home this year?
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

Use this worksheet only if you answer "Yes" to all of the following questions.
- Did you use the dwelling unit as a home this year? (See *Dwelling Unit Used as a Home*.)
- Did you rent the dwelling unit at a fair rental price 15 days or more this year?
- Is the total of your rental expenses and depreciation more than your rental income?

PART I. Rental Use Percentage

A.	Total days available for rent at fair rental price	A.	343
B.	Total days available for rent (line A) but not rented	B.	265
C.	**Total days of rental use.** Subtract line B from line A	C.	78
D.	**Total days of personal use** (including days rented at less than fair rental price)	D.	22
E.	**Total days of rental and personal use.** Add lines C and D	E.	100
F.	**Percentage of expenses allowed for rental.** Divide line C by line E	F.	78%

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:
1. 14 days, or…
2. 10% of the total days it is rented to others at a fair rental price.

IRS Worksheet 5-1 Part II

PART II. Allowable Rental Expenses				
1.	Enter rents received		1.	$15,600
2a.	Enter the rental portion of deductible home mortgage interest and qualified mortgage insurance premiums. See instructions	2a. $9,516		
b.	Enter the rental portion of deductible real estate taxes. See instructions	b. $2,886		
c.	Enter the rental portion of deductible casualty and theft losses. See instructions	c.		
d.	Enter direct rental expenses. See instructions	d.		
e.	**Fully deductible rental expenses.** Add lines 2a–2d. Enter here and on the appropriate lines on Schedule E. See instructions		2e.	$12,402
3.	Subtract line 2e from line 1. If zero or less, enter -0-		3.	$3,198

IRS Worksheet 5-1 Part II (cont.)

4a.	Enter the rental portion of expenses directly related to operating or maintaining the dwelling unit (such as repairs, insurance, and utilities)	4a.	$4,836		
b.	Enter the rental portion of excess mortgage interest. See instructions	b.			
c.	Enter the rental portion of excess real estate taxes. See instructions	c.			
d.	Carryover of operating expenses from 2021 worksheet	d.			
e.	Add lines 4a–4d	e.	$4,836		
f.	**Allowable expenses.** Enter the **smaller** of line 3 or line 4e. See instructions			4f.	$3,198
5.	Subtract line 4f from line 3. If zero or less, enter -0-			5.	
6a.	Enter the rental portion of excess casualty and theft losses. See instructions	6a.			
b.	Enter the rental portion of depreciation of the dwelling unit	b.	$4,290		
c.	Carryover of excess casualty and theft losses and depreciation from 2021 worksheet	c.			
d.	Add lines 6a–6c	d.	$4,290		
e.	**Allowable excess casualty and theft losses and depreciation.** Enter the **smaller** of line 5 or line 6d. See instructions			6e.	$0

$1,638 deferred!

Worksheet 5-1 Part III

Line 4e	$4,836
-Line 4f	$3,198
	= $1,638

Line 6d	$4,290
-Line 6e	$ 0
	= $4,290

PART III. Carryover of Unallowed Expenses to Next Year		
7a. **Operating expenses to be carried over to next year.** Subtract line 4f from line 4e	7a.	$1,638
b. **Excess casualty and theft losses and depreciation to be carried over to next year.** Subtract line 6e from line 6d	b.	$4,290

And the Unused Losses?

- They are carried forward to the next year.
- And then the next year…
- And then the next year…
- The IRS has not told us that these unused losses can offset gain from the sale, so they are probably just lost.

That’s a Lot of Effort…

I don’t think I’m charging enough for these types of rentals…

Probably not…

QUIZ

Which situation is subject to the ordering rules?

a. Verna used her London flat for 30 days and rented it out for 10 days.
b. Susie used her Florida beach house for 13 days and rented it out for 180 days.
c. Tom used his Vegas condo house for 30 days and rented it out for 290 days.

Section 11

§121 Exclusion

§121 Exclusion Three Tests

- **Ownership Test:** Owned directly by taxpayer for at least two years during the five-year period before the sale of the home.
- **Use Test:** Occupancy of the principal residence IS required for at least 2 years out of the 5-year period ending on sale date.
- **Lookback Test:** If taxpayer didn't sell another home during the two year-period utilizing the §121 exclusion, then this test is met.
- How is the §121 exclusion used for property that was also used as a rental?

Sale of Dwelling Acquired for Rental Use with Personal Use

- "Housing Assistance Act of 2008" amended I.R.C. Section 121 to provide that gain from the sale or exchange of a principal residence allocated to periods of "nonqualified use" is **not excluded** from gross income in the event of a “home sale.”
- A nonqualified use can occur only **before** the home was used as the taxpayer’s principal residence.
- Time periods **after** the home was used as the principal residence do not constitute a nonqualified use.

Edward Sells His House

- Edward owned and used his house as his principal residence since 1990.
- On January 1, 2020, Edward moves to another state and rents out his house.
- He sells the house on April 18, 2022.
- The 5-year period of interest is April 19, 2017 – April 18, 2022.
- Edward owned and used the house for two years during that 5-year period and so qualifies for §121 exclusion.

Charlie Sells His House

- Charlie owned and used his house as his principal residence since 1990.
- On January 1, 2019, Charlie moves to another state and rents out his house.
- He sells the house on April 18, 2022.
- The 5-year period of interest is April 19, 2017 – April 18, 2022.
- Charlie only used the house for one and a half years during that 5-year period and so doesn't qualify for §121 exclusion.

Darla Sells Her House

- Darla purchased a dwelling to be used as a rental.
- The rented her property to tenants for 7 years.
- Then she moved into it and used it as a principal residence for 2 years.
- Then she sold it…
- She has owned it for 9 years and had 7 years of NQ use = 7/9 = 0.778%.
- Darla must reduce her exclusion for this period of nonqualified use! (But you'd calculate number of DAYS in real life).

Allocating Gain/Loss Between Residence and Rental

- Renting the home may affect the gain or loss calculations when the home is sold.
- If the space you used for business or rental purposes was within the living area of the home, then your usage **doesn't** affect your gain or loss calculations.
  - Examples of spaces within the living area include a rented spare bedroom or attic space used as a home office.
  - In contrast, business or rental spaces not within the living area will affect your gain/loss calculations.
  - Examples of space not within the living area include a first-floor storefront with an attached residence; a rented apartment in a duplex; or a working farm with a farmhouse on the property.

Specific Portion Used by the Seller for Personal Use

- Multi-Unit Building:
  - If the taxpayer lived in one of the residences and rents out the others, such as the case with a duplex, then the rental portion of the building stands alone and is treated and depreciated as any other rental.
  - The sale of the property is reported as part home sale and part sale of rental.

Section 12

Some Final Thoughts

When is a Rental Not for Profit?

- If there's no profit motive in the rental activity, then the income is reported as other income on Schedule 1 (Form 1040), Part I, Line Z.
  - Charging less than fair market rent.
  - Slow to collect back rent.
  - Failing to take legal actions for arrears/damages.
  - Allowing rentals to remain vacant for periods of time.
- **Can deduct expenses up to the amount of income, no loss allowed!**

Avoiding the Trap

- In the absence of a tenant, the burden of proof falls on the taxpayer to show a for-profit motive, including advertising the home in multiple locations, meeting with tenants, adjusting the rent as necessary.
  - Keep good business records.
  - Keep track of the time you spend on the rental activity.
  - Keep a separate bank account for the rental activity.
  - Take steps to increase rental income.

Vacant Property

- Uncollected rent is not included in income for cash basis taxpayers (so it isn't deductible).
- Expenses for maintaining the property while it's vacant are deductible.
- If you are holding it for sale, those expenses are **not** deductible if it isn't available for rent during that time period.

Donation of Use

- Sam donates two weeks at his lake house to his favorite charity to be used in a silent auction.
- He tells you he has a charitable deduction for the amount of fair rental value for those two weeks.

What will you tell him?

Self Rentals

- Self Rental Rule: Income generated from renting a property to a trade or business in which the property owner materially participates is recategorized as non-passive.
- Also applies if the entity, trade or business to which the owner is renting is a C Corp or any other pass-through entity.
- Also applies if one spouse owns the property and another spouse pays the rent.

Self Rental Trap

- Brad is a limited partner in a partnership.
- He’s allocated a $10,000 loss from the partnership.
  - He doesn’t have passive income to absorb the loss.
- He’s also the major shareholder in an S Corp.
- He purchases a commercial building to rent to the S Corp.
  - Brilliant idea! That’ll generate passive income to offset the passive loss!
  - Too bad, so sad – that passive income is now characterized as nonpassive, so he can’t offset that income with the partnership loss.

Rentals Held in LLCs

- Legally, it's a good idea for rental property to be held in an LLC.
  - Limits owner liability to the value of that specific investment.
  - Easier to administer than other entity types.
  - Separate tax return not required.
  - Anonymity on public record.
- This is a legal strategy, not a tax strategy!

Which might be not-for-profit rentals?

a. Bob rents out his beach condo to his son for $10 a month.

b. Charlie rents a mountain cabin to a friend who is going through a bad time; the friend pays whatever he can afford each month.

c. Donna rents a small house to a friend at FRV. The friend is 3 months behind in rent and Donna has hired her attorney to evict them.

d. Evan rented his Hawaiian condo to some old schoolmates at FRV; they caused quite a bit of damage, but he has decided to take no action. After all, they’re friends.

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