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Rental of Residences

It Is No Longer a Simple Transaction, Thanks to the Passive Activity Rules

The Tax Reform Act of 1986 (TRA), Revenue Act of 1987 and Technical and Miscellaneous Revenue Act of 1988 (TAMRA) made several changes to the tax treatment of the income or loss from the rental of a residence. No longer is all mortgage interest on a residence or a loss on rental property automatically deductible. The current tax treatment of rental residences unfortunately requires a trip through a maze of Code sections.

In most situations, a taxpayer who rents out a residence will have to consider certain tax provisions that limit deductions and/or losses. Three possible limitations are:

☐ Sec. 280A—Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Homes, Etc.

☐ Sec. 469—Passive Activity Losses and Credits Limited.

☐ Sec. 183—Activities Not Engaged in for Profit.

Typically, the loss from the rental of a residence will be usable only against future income. Thus, knowing the rules and planning accordingly become imperative in order to use losses fully in future years whenever possible.

This article will discuss the basic rules for the rental of a residence; map out the proper path through the maze of rules, based on the particular rental facts, via a flowchart (see page 535); explain each tax end result of the flowchart with examples; and provide planning tips to aid in obtaining the optimum tax treatment for any rental situation.

Explaining the Rules —A Flowchart Approach

▪ Definitions

Dwelling unit: Sec. 280A(f)(1) defines a dwelling unit to include a house, apartment, condominium, mobile home, boat or similar property, along with the structures or other property appurtenant to the unit. The term does not include any portion of a unit used exclusively as a hotel, motel, inn or similar establishment. The proposed regulations under Sec. 280A provide further that the dwelling unit must provide basic living accommodations (sleeping space, toilet and cooking facilities). One structure, such as an apartment building or a house with a basement containing basic living accommodations, would be considered to contain more than one dwelling unit.[1] Also, a dwelling, or portion thereof, is considered to be used as a hotel, motel, inn or similar establishment if it is regularly available to paying customers and no one with an interest in the unit is treated under Sec. 280A(d) as having used the unit as a residence during the year.[2]

[1] Prop. Regs. Sec. 1.280A-1(c)(1).
[2] Prop. Regs. Sec. 1.280A-1(c)(2).

Personal use: Under Sec. 280A(d)(2) and (3) and Prop. Regs. Sec. 1.280A-1(e)(1), the use of a dwelling unit for "personal use" includes
—days used by the owner and any co-owner(s);
—days used by a relative[3] of any owner, unless used by him as a principal residence;
—days used by a person who has exchanged use of another dwelling with the owner (regardless of what rental amount is charged); and
—days of use by an individual (other than an employee using it under Sec. 119) at less than fair rental.
Additional rules apply to determine personal use when the dwelling is owned by a partnership, trust, estate or S corporation.[4]

As required by Sec. 280A(d)(2), the regulations provide that a dwelling will not be treated as used for personal purposes on any day when the principal purpose for use is to perform repair or maintenance work. The facts and circumstances such as the time devoted to repair work, frequency of "repair" days, and the presence and activities of companions are used to determine whether the principal purpose of a particular day of use is for repairs. However, any day in which the taxpayer performs repair and maintenance work on a substantially full-time basis will not be treated as a personal use day.[5]

Fair rental: While "fair rental" is not specifically defined in the Code or proposed regulations, the legislative history to Sec. 280A and court cases provide some guidance.

Charging a fair rental is necessary to prevent the tenant's use of the dwelling from being treated as personal use days of the owner.[6] The definition of fair rental depends on whether or not the tenant is a relative or a co-owner. (Relatives include an individual's brothers, sisters, spouse, ancestors and lineal descendants.[7])

☐ If the tenant is not a relative or a co-owner, the rental will be fair if it is comparable to other rents in the area.[8]

☐ If the tenant is a relative, but not a co-owner, the days that the relative is a tenant will be treated as personal use days of the owner unless the relative uses the dwelling as a principal residence (see Flowchart, Step III).[9]

For example, if a brother rents the owner's beach house for one week and pays the market rate for such use, the owner will have an additional seven days of personal use, since the brother did not use the beach house as a principal residence. If the relative does use the dwelling as a principal residence, fair rent must be charged or the owner will have the burden of proving that the rental activity is an activity engaged in for profit under Sec. 183.

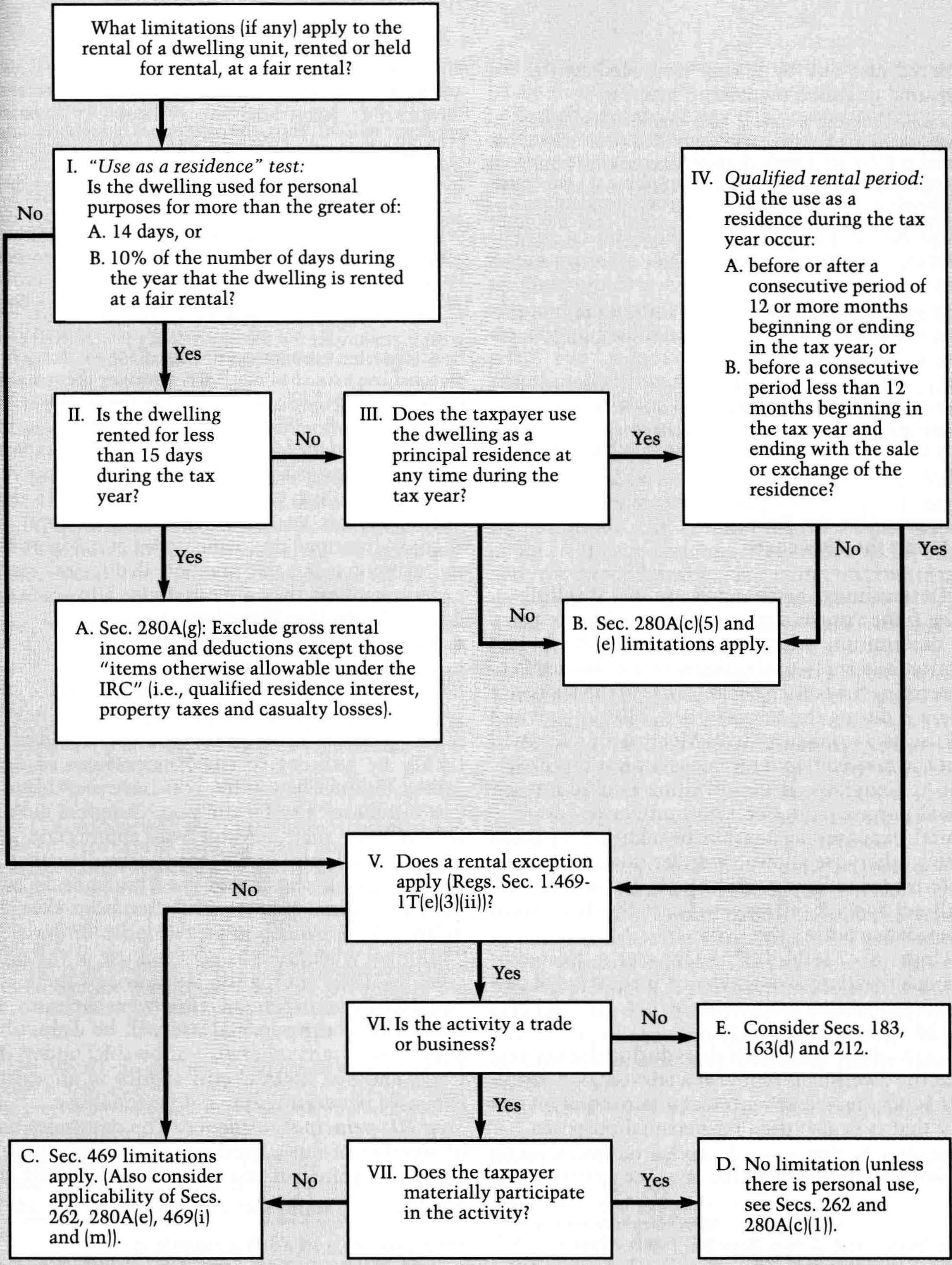
The legislative history indicates that the existence of a fair rental depends on two factors.
1. Comparable rentals in the area.
2. Whether substantial gifts were made by the taxpayer to the family member at or about the time of the lease, or periodically during the year.[10]

The family relationship may allow a less than fair market rent to be considered a fair rental. For example, in *Bindseil*,[11] an owner rented a house to his parents for use as a principal residence. The issues were whether a fair rent was being charged and, if so, whether the owner was engaged in an activity for profit. The Tax Court relied on IRS testimony of comparable rents in the area to determine fair rental. The court then allowed that amount to be discounted by 20% because a management fee of between 5% and 10% of the rental fee had been avoided by the owner, and below market rent was justified since the tenants (who were relatives) were trustworthy and would take unusually good care of the property (thus keeping maintenance and repair costs low).

☐ If the tenant is a co-owner, the determination of a fair rental depends on the existence of a "shared equity financing agreement." This is an agreement under which two or more persons acquire a qualified ownership interest (an undivided interest for over 50 years in the entire dwelling and attached land). One or more of the owners must be entitled to occupy the dwelling as a principal residence and required to pay rent to the other owner(s).[12] The fair rental in such a situation is to be determined at the time the agreement is

[3]As defined in Sec. 267(c)(4).
[4]See Prop. Regs. Sec. 1.280A-1(e)(5).
[5]Prop. Regs. Sec. 1.280A-1(e)(6).
[6]Sec. 280A(d)(2)(C).
[7]As defined in Sec. 267(c)(4).
[8]Summary of HR 5159 by the Staff of the Joint Committee on Taxation, at 11.
[9]Sec. 280A(d)(3)(A).
[10]Summary of HR 5159, note 8, at 11.
[11]*Lee A. Bindseil*, TC Memo 1983-411.
[12]Sec. 280A(d)(3)(C) and (D).

Flowchart: Limitations on the Rental of a Dwelling Unit



entered into and by taking into account the occupants' qualified ownership interest.[13]

Example 1: A and *B* have a 50% qualified ownership interest each in a house that *B* is entitled to occupy. If fair rental is $500 per month, *A* must receive $250 per month in order to be treated as renting the dwelling at a fair rental. Although not addressed in the proposed regulations, discounting similar to that in the *Bindseil* case should be applicable if the co-owner is a relative, since Sec. 280A(d)(3)(B)(ii) does not appear to prevent such a conclusion.

If the dwelling is owned by more than one taxpayer, the fair rental determination applies separately to each co-owner.

Example 2: A and *B* own 50% each of a house that they rent to unrelated party *C*. Fair rental is $500 per month. *A* charges *C* $250 per month and thus receives fair rental However, *B* charges *C* only $150 per month and thus does not receive fair rental.[14]

Mapping Out the Rules —Using the Flowchart

■ Determining the personal use of a dwelling

Step I: the "use as a residence" test: The first step in determining what potential deduction or loss limitations apply to the rental of a residence is to determine how much personal use of the residence there is during the tax year. Sec. 280A(d) provides a "use as a residence" test. Meeting this test will put the taxpayer under the loss limitations of Sec. 280A. Generally, if the dwelling is used for personal purposes for a certain number of days, the rental expenses deductible in addition to those items otherwise allowable under the Code will be determined under Sec. 280A(c)(5) and (e). Sec. 469 will not apply if the taxpayer uses the dwelling as a residence during the tax year.[15]

Under Sec. 280A(d)(1), a taxpayer is treated as using a dwelling as a residence if the days of personal use exceed the greater of:

(A) 14 days, or

(B) 10% of the number of days during the tax year that the dwelling is rented at a fair rental. A dwelling is not treated as rented at a fair rental on any day that it is also used for personal purposes.

Example 3: In 1990, owner *X* uses her vacation home for 18 days and rents it out for 100 days. The greater of (A) or (B) in the Sec. 280A(d)(1) test is 14 days (i.e., 14 days is greater than 10% of 100 days). Since *A* uses the home more than 14 days, she is treated as using the dwelling as a residence in 1990. Thus, she determines her rental income or loss for 1990 by applying Sec. 280A(c)(5). (See Flowchart Result B.)

Example 4: In 1990, owner *Z*'s yacht is used 14 days by *Z* and/or his family; 136 days at a fair rental; and five days at a fair rental for a trip on which *Z* was present.

Since a dwelling is not treated as rented at a fair rental for any day it is also used for personal purposes, the five-day trip is added to the 14 days of personal use. Thus, *Z* has 19 days of personal use and 136 days of rental use. The greater amount in the use of residence test is (A) (i.e., 14 days is greater than 10% of 136 days). Since *Z*'s days of personal use exceed 14 days, *Z* determines the rental income or loss for 1990 by applying the limitations of Sec. 280A(c)(5) and (e). (See Result B.)[16]

Step II: rental for less than 15 days: If the taxpayer meets the "use as a residence" test for the tax year and the dwelling is rented for less than 15 days during the tax year, Sec. 280A(g) will apply. In such a situation, the owner need not report the rental income, but also must not deduct any rental expenses unless they are otherwise allowable under the Code. (See Flowchart Result A.)

■ Potential benefit if dwelling is a principal residence

Before the Revenue Act of 1978 was enacted, if a taxpayer converted his principal residence to rental property during a tax year, he would most likely be subject to the limitations of Sec. 280A(c)(5) since he was likely to have met the "use as a residence" test for the year. Congress did not believe that such a result was appropriate and added special rules to prevent the disallowance of deductions for the period the residence is converted to rental property.[17] Relief from the Sec. 280A(c)(5) limitations is available under Sec. 280A(d)(4) when there is personal use of the principal residence during the tax year and there is a "qualified rental period." However, expenses attributable to the personal use will be deductible only if they are otherwise allowable under the Code, and Sec. 280A(e) still applies in allocating expenses between rental and personal use.

Step III: principal residence: The determination of whether or not a residence is used by the taxpayer as a principal residence is made under the

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[13]Sec. 280A(d)(3)(B)(ii); Prop. Regs Sec. 1.280A-1(e)(3).
[14]Prop. Regs. Sec. 1.280A-1(g).
[15]Sec. 469(j)(10).
[16]Prop. Regs. Sec. 1.280A-1(d)(2), Example (2).
[17]*General Explanation of the Revenue Act of 1978*, prepared by the Staff of the Joint Committee on Taxation, at 366.

Sec. 1034 regulations and depends on all the facts and circumstances, including the good faith of the taxpayer.[18] Generally, the determination is an issue only when a taxpayer uses more than one residence. Then, facts and circumstances are relevant in determining which residence is the principal one.

Step IV: qualified rental period: Sec. 280A(d)(4)(B) defines a qualified rental period as a consecutive period during which the principal residence is rented, or is held for rental, at a fair rental. A qualified rental period can be either:

1. A period of 12 or more months that begins or ends in the tax year, or
2. a period less than 12 months that begins in the tax year and ends when the dwelling is sold or exchanged.

If the taxpayer's personal use of the principal residence occurs before or after period 1, such use is not treated as personal use. If the use occurs before period 2 (obviously not after, since the residence is sold), such use is also not treated as personal use.

Example 5: X puts her principal residence up for sale on Feb. 1, 1990. She moves into a rented apartment on Mar. 1, 1990 and temporarily rents out the old residence on Mar. 15, 1990. The old residence is sold on Nov. 1, 1990. During 1990, the old residence is used 59 days by *X* as her principal residence, and rented 230 days at a fair rental. (The remaining days of 1990 are irrelevant because *X* sold the house on Nov. 1, 1990.)

Applying the use as a residence test (Step I), the greater of (A) or (B) is (B) (i.e., 23 days (10% of 230 days) is greater than 14 days). Since *X* uses the residence for personal purposes for more than 23 days, the rental loss, if any, would be subject to the limitation of Sec. 280A(c)(5). However, that limitation will not apply in 1990 because *X*'s personal use will be disregarded since it occurs before a qualified rental period (a period less than 12 months beginning in 1990 and ending on the sale of the residence). Thus, *X*'s rental activity would be subject to the loss limitation rules of Secs. 469 and 280A(e) (Flowchart Steps V through VII) since Sec. 280A(c)(5) will not apply. Before the existence of Sec. 469, the loss would have been fully allowable in the year it occurred.

Query: Would the qualified rental period have ended if *X* bought a new residence while the old one was still rented? The proposed regulations under Sec. 280A do not address this situation.

■ Applicable rules when dwelling is not "used as a residence"

If the use as a residence test (Step I) is not met, the rental may be subject to the rules of Sec. 469 (since Sec. 280A(c)(5) would not apply). Sec. 469 will apply if the activity is a "rental activity" or if it is a "trade or business" in which the owner does not "materially participate."

Step V: rental activity and exceptions: The starting point for identifying a rental activity is to identify the rental undertakings. A rental undertaking is the business and rental operations of making tangible property available for use by customers along with any related property and services that are at one location and owned by the same person.[19] For example, if an individual owns two rental condominiums in the same complex, he has one undertaking. Generally, each undertaking constitutes one activity.[20] However, special rules generally allow rental real estate undertakings to be aggregated or divided as the taxpayer chooses as long as they are treated consistently each year.[21] For example, the condominium owner above could treat each condominium unit as a separate activity. An undertaking is a rental real estate undertaking if at least 85% of the unadjusted basis of the property made available to customers is real property.[22]

Each rental undertaking must be tested to determine whether it is a "rental activity" under Sec. 469. Generally, an activity is a "rental activity" if the gross income generated from the activity represents amounts paid principally for the use of tangible property.[23] Of the six exceptions in Temp. Regs. Sec. 1.469-1T(e)(3)(ii), the following are relevant in a rental of a residence situation.

☐ If the average period of customer use of the property is seven days or less, the activity is not a rental activity. Common examples are the rental of automobiles, videocassettes, hotel rooms and, often, vacation homes. The rationale for this exception is that such short-term customer use will generally require the owner to provide services that are significant enough to show that the owner is engaged in a service business, rather than a rental activity.[24]

☐ If the average period of customer use of the

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[18] Regs. Sec. 1.1034-1(c)(3)(i).

[19] Temp. Regs. Sec. 1.469-4T(d)(3) and (c).
[20] Temp. Regs. Sec. 1.469-4T(b)(1).
[21] Temp. Regs. Sec. 1.469-4T(k).
[22] Temp. Regs. Sec. 1.469-4T(k)(1)(ii).
[23] Sec. 469(j)(8); Temp. Regs Sec. 1.469-1T(e)(3)(i).
[24] TD 8175, 1988-1 CB 191, at Section II.B.

property is 30 days or less and significant personal services are provided, the activity is not a rental activity. For example, if significant personal services are provided in the operation of a hotel or lodge where guests stay for an average period exceeding seven days, but not 30, the activity is not a rental activity. In determining whether the personal services provided are significant, all relevant facts and circumstances are considered, including the frequency of service, the type and amount of labor required, and the value of the services in relation to the amount charged for the use of the property.[25]

The determination of whether an activity is a rental activity must be done on an annual basis. An activity can be a rental activity in one tax year, but not in the next. If an activity is not a rental activity (because one of the exceptions applies), Sec. 469 will apply only if the activity is a trade or business in which the owner does not materially participate.

An activity involving the rental of a dwelling unit that is used as a residence within the meaning of Sec. 280A by the taxpayer during the tax year is not a passive activity.[26]

Step VI: trade or business: An activity is generally considered a trade or business if it involves the conduct of a trade or business within the meaning of Sec. 162. Regulatory authority was granted to expand the definition of trade or business activity to include certain activities connected with a trade or business and certain Sec. 212 type activities.[27] The IRS exercised this authority in the second set of temporary regulations under Sec. 469, which provide that endeavors conducted in anticipation of becoming a trade or business may be treated as a trade or business for Sec. 469 purposes.[28]

Step VII: material participation: Material participation is involvement in an activity that is regular, continuous and substantial.[29] The tests to determine material participation under Temp. Regs. Sec. 1.469-5T(a) are always applied to an individual even if the activity is in a partnership or a corporation. If any one of the seven tests is met, the individual is treated as materially participating in the activity. The tests must be applied each tax year. The following six tests are relevant for a trade or business involving a residence.

1. The individual participates in the activity more than 500 hours.
2. The individual's participation constitutes substantially all of the participation of all individuals (including nonowners) in the activity.
3. The individual participates in the activity more than 100 hours and not less than any other individual.
4. The activity is a "significant participation activity" and the individual's aggregate participation in all such activities is more than 500 hours.[30]
5. The individual materially participated in the activity for any five tax years during the 10 preceding tax years.[31]
6. An individual materially participates if, based on all the facts and circumstances, the individual participates on a regular, continuous and substantial basis. Such participation must exceed 100 hours in the tax year.

Participation generally means any work done by an individual, in any capacity, including work performed by a spouse. Time spent at work that is not of a type customarily done by owners, or investor type work such as reviewing financial statements (in a nonmanagement capacity) will not constitute participation.[32] In measuring hours of participation under any of the tests, annualization is not permitted (or required).

The Tax Consequences

As shown in the flowchart, after applying the above definitions and tests (Steps I to VII), the rental should fall into one of five different tax results.

A. Minimal rental use.
B. Use as a residence.
C. Passive activity.

[25]Temp. Regs. Sec. 1.469-1T(e)(3)(iv).
[26]Temp. Regs Sec. 1 469-1T(e)(5)
[27]Sec. 469(c)(6).
[28]Temp. Regs. Sec. 1.469-4T(b)(2)(ii)(*1*)
[29]Sec. 469(h)(1).

[30]Temp. Regs. Sec. 1.469-5T(c) defines a significant participation activity, generally, as a nonrental activity in which the individual participates for more than 100 hours, but does not otherwise meet a material participation test.
[31]The material participation of an individual for a tax year beginning before Jan. 1, 1987 is based only on the over-500-hour test. Temp. Regs. Sec. 1.469-5T(j)(2).
[32]Temp. Regs. Sec. 1.469-5T(f)