

## SECTION 280A: VACATION HOME AND RENTAL PROPERTY

Internal Revenue Code Section 280A ("280A") governs the rental of a vacation home or dwelling unit (collectively "unit"). Although the rules are complex, a proper analysis can permit a taxpayer to maximize both the personal use of the unit and the cash flow and tax benefits generated from the rental of the unit.<sup>1</sup> Through advance planning, a taxpayer can use a unit for personal enjoyment and still retain certain benefits from it as rental property. As a rental unit, expenses incurred are netted against revenues received on "Schedule E" of a taxpayer's federal income tax return.<sup>2</sup> The taxpayer is then able to turn otherwise non-deductible personal expenses into deductible business expenses. The unit becomes both a "tax shelter" and a personal vacation site.<sup>3</sup>

While the rules under 280A are principally directed at the combination of rental and personal use of a vacation home, the rules also apply to the rental of any dwelling unit used or considered to be used by the taxpayer as a residence.<sup>4</sup> Therefore, the rules apply where a taxpayer rents out a permanent residence while elsewhere on vacation.<sup>5</sup>

In addition to the personal and business use of a unit, the rules under 280A also cover situations such as time-sharing arrangements, rental pools, shared equity financing deals and office-at-home deductions.<sup>6</sup> Though 280A applies to individuals, partnerships, trusts, estates, and S Corporations, this comment assumes the "taxpayer" to be an individual taxpayer.<sup>7</sup> This author

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<sup>1</sup>Dalton, Jr. and Bristow, *Maximizing After-tax Return on Vacation Property Rental Requires Special Case*, TAXATION FOR ACCOUNTANTS, June 1984, at 348, 348 [hereinafter cited as Dalton].

The Tax Court has called Section 280A a "labyrinthine disallowance formula and a tortuous path of . . . exasperatingly convoluted provisions." *Bolton v. Commissioner*, 77 T.C. 104, 109 (1981).

<sup>2</sup>For an individual taxpayer, net profit or loss from a rental unit is placed on Schedule E of Federal Form 1040 and is an item which determines adjusted gross income for the taxpayer. This is sometimes referred to as an "above-the-line" deduction because it is used to compute adjusted gross income on Federal Form 1040.

<sup>3</sup>Deductions attributable to rental activities are generally those items that are of a type allowable only as expenses incurred in connection with a trade or business under Section 162 or in the production of income under Section 212. Expenses which are attributable to personal purposes are generally nondeductible under Section 262. The limitation for personal purposes under Section 262 does not apply to expenses such as mortgage interest, property taxes, and casualty losses which are otherwise deductible by the taxpayer even if he or she does not rent the unit. The personal portion of these expenses are deducted on Schedule A of Federal Form 1040 and are items which reduce adjusted gross income to determine taxable income. This is sometimes referred to as a "below-the-line" deduction because it is below the adjusted gross income line on Federal Form 1040.

<sup>4</sup>Research Institute of America, Inc., RIA REAL ESTATE COORDINATOR, ¶ 66,901 (1985); I.R.C. § 280A(2) (1986).

<sup>5</sup>*Id.*

<sup>6</sup>Prop. Reg. § 1.280A (1983).

<sup>7</sup>H.R. Rep. No. 658, 94th Cong., 1st Sess. 4 (1975), 1976-3 C.B. 695, 856 (Vol. 2). With respect to corporations other than S Corporations, see Section 274(g), I.R.C.

will first analyze 280A to provide general guidance in the rental of a unit. After the overall analysis, the author will focus on the following rental situations:

1. Analysis of Personal Use.
2. Analysis of Rental Use.
3. Further Analysis of Allocating Rental & Personal Expenses.
4. Rental Pools and Time Sharing Arrangements.
5. Tax Planning Ideas.
6. The Impact of the Tax Reform Bill.

Finally, the author will offer a brief conclusion on 280A and its application to the vacation home and rental market.

### ANALYSIS OF 280A

#### *History:*

In 1976, Congress enacted Section 280A dealing with the tax treatment of vacation homes in response to general congressional displeasure with the marketing of vacation homes. The marketing emphasized the tax benefits of renting the property for part of the year while also retaining it for personal use.<sup>8</sup> The legislative history of 280A reflects an overall congressional disapproval of converting nondeductible personal expenses into deductible rental expenses.<sup>9</sup> Congress feared that Section 183, I.R.C., which merely prevents the use of hobby losses to offset income from other sources, had an uncertain application to the rental of vacation homes.<sup>10</sup> In 280A, Congress specified the extent to which personal use of a unit would result in the disallowance or allocation of deductions on Schedule E.<sup>11</sup> Unlike Section 183, 280A does not probe the taxpayer's motive or intent but operates solely by reference to the taxpayer's personal use of the unit.<sup>12</sup>

#### *In General:*

The key to the limitations under Section 280A is the taxpayer's personal use of the unit.<sup>13</sup> The law under 280A specifically limits deductions of expenses where the taxpayer is using the unit as a "residence" during the taxable year.<sup>14</sup>

In order to calculate allowable deductions with respect to a unit, a tax-

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<sup>8</sup>S. Rep. No. 938, 94th Cong., 2nd Sess. 150 (1976), 1976-3 C.B. 188, 190 (Vol. 3); Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525 (1976).

<sup>9</sup>*Id.* at 189-90.

<sup>10</sup>*Id.* at 188-89.

<sup>11</sup>Joint Comm. on Tax., 94th Cong., 2nd Sess. 436, General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. 153, 155 (Vol. 2).

<sup>12</sup>*Id.* at 156.

<sup>13</sup>Dalton, *supra* note 1, at 349.

<sup>14</sup>Weber, *Determining Deductibility of Expenses Related to Residence Rental: A Current Analysis*, THE JOURNAL OF TAXATION, March 1984, at 158, 158.

payer must first determine whether the unit has been used for personal purposes during the year and whether the taxpayer's personal use was excessive enough to warrant treating the unit as a "residence."<sup>15</sup>

If the taxpayer has used the unit for personal purposes for even one day, all expenses must be allocated between rental days and personal days. Expenses attributable to personal use days are generally nondeductible.<sup>16</sup> Though interest, taxes, and casualty losses must be allocated between personal and rental use days, no limitation is placed on the amount a taxpayer may deduct, as these items are allowable without regard to a trade or business or income producing activity.<sup>17</sup> The individual deducts the personal portion of interest, taxes, and casualty losses on Schedule A of Federal Form 1040 ("Schedule A") while allocable rental revenue and expenses are reported on Schedule E of Federal Form 1040 ("Schedule E").

If a taxpayer has used the unit for personal purposes for the greater of (a) 14 days or (b) 10% of the number of days during such year that the unit is rented at fair market rental, then the unit is treated as having been used as a residence ("residence usage").<sup>18</sup> In such a case, the deduction for expenses (other than interest, taxes, and casualty losses allocated to Schedule A) are limited on Schedule E to gross rental income reduced by the portion of interest, taxes, and casualty losses that are attributable to the rental use.<sup>19</sup>

If the taxpayer has used the unit for personal purposes less than the greater of (a) 14 days or (b) 10% of the number of days during such year that the unit is rented at fair market rental, then the unit is not treated as having been used as a residence ("limited personal usage").<sup>20</sup> In such a case, expenses must be allocated between rental days and personal days, but those expenses allocated to the rental days may exceed gross rental income on Schedule E.<sup>21</sup>

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<sup>15</sup>Fudeman, *How to Minimize the Section 280A Limitations on Rental Losses*, THE PRACTICAL ACCOUNTANT, December 1984, at 45, 46.

<sup>16</sup>Prop. Reg. § 1.280A-3(c)(1), (3) (1983). In *Bucholz v. Commissioner*, 83 T.C.M. (P-H) 1543 (1983), the Tax Court held that "day" means calendar day, not hotel day, which is the 24 hour period starting at check-in on one calendar day and ending at check-out time on the following calendar day.

<sup>17</sup>I.R.C. § 280A (1986). The portion of interest, taxes, and casualty losses attributable to personal use is deductible on Schedule A. The personal use deduction for interest is allowable under Section 163, I.R.C.; the personal use deduction for taxes is allowable under Section 164, I.R.C.; and the personal use deduction for casualty losses is allowable under Section 165, I.R.C.

<sup>18</sup>I.R.C. § 280A(d)(1) (1986).

<sup>19</sup>I.R.C. § 280A(c)(5) (1986).

<sup>20</sup>Enis, *Vacation Homes: Tax Treatment and Tax Planning Based on a Mathematical Formulation*, 12 J. REAL. EST. TAX. 52, 56 (1984).

<sup>21</sup>*Id.* The tax treatment for this unit is the same as residence usage except that net losses will be allowed on Schedule E if the rental activity is deemed to be one entered into profit under the "hobby loss" rules of Section 183, I.R.C. Such losses can effectively offset other sources of income on the Federal Form 1040. This is sometimes referred to as a real estate "tax shelter." Section 183 provides a list of relevant factors to be considered in determining whether the rental activity is engaged in for a profit. These include (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer and his advisors; (3) the taxpayer's history of income and loss with respect to the property; and (4) elements of personal pleasure or

There is also a *de minimis* rule under 280A where the unit is rented for less than 15 days during the year ("*de minimis* rental").<sup>22</sup> Under the *de minimis* rule, the taxpayer disregards both the rental income and all expenses other than the Schedule A deductions for interest, taxes, and casualty losses.<sup>23</sup>

### *Order of Deductions:*

If a unit is used solely as rental property and is not used for personal purposes or as a residence, the rules under 280A do not apply and the taxpayer can deduct rental expenses without limitation.<sup>24</sup>

If the taxpayer used the unit for personal and rental purposes, the expenses must generally be placed in one of the following three categories, with the rental portion being deductible in the following order:

- (1). The allocable portion of amounts which are allowable in any event, such as interest, taxes, and casualty losses;
- (2). The allocable portion of amounts which are allowable by reason of the rental use of the unit, other than those which would result in an adjustment to the basis of the property, such as insurance and utilities;
- (3). The allocable portion of amounts which are allowable by reason of the rental use of the unit, which would result in an adjustment to the basis of the property, such as depreciation of the building and personal property.<sup>25</sup>

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recreation in the activity. Section 183(d) also provides a presumption that an activity is carried on for a profit if for any two out of five consecutive tax years, the gross income exceeds deductions attributable to the property.

<sup>22</sup>Prop. Reg. § 1.280A-3(b) (1983).

<sup>23</sup>*Id.*

<sup>24</sup>Fudeman, *supra* note 15, at 46. This also assumes the rental property is engaged in for profit under Section 183, I.R.C. and is not subject to the investment interest expense limitations under Section 163(d), I.R.C.

In *Betran v. Commissioner*, 43 T.C.M. (CCH) 892 (1982), the IRS did not attack the taxpayer's personal use of his unit under 280A but rather argued that the taxpayer's holding of the unit was an activity not engaged in for profit within the meaning of 183(c). The IRS prevailed because the taxpayer failed to maintain adequate records to support his business purpose.

In IRS Letter Ruling 8150064, the IRS ruled that the investment interest rule of Section 163(d), I.R.C. applies where a taxpayer owns a unit for rental purposes. In general, interest is usually deductible in the year it is paid or accrued. However, the deduction of "investment interest" may be subject to substantial limitations in any given year. In Section 163(d)(3)(D), investment interest is defined as interest paid or accrued on indebtedness incurred to purchase or carry property held for investment. In Section 163(d)(4)(B), investment interest does not include interest paid in connection with trade or business property. Therefore, a taxpayer wants to be connected with a trade or business property to avoid any investment interest limitation. In 163(d)(4)(A), property that is subject to a "net lease" is not regarded as property used in a trade or business. In Section 163(d)(4)(A), the Code defines a "net lease" as a lease that satisfies either one of two tests: (1) If the sum of the lessor's deductions with respect to a unit allowable solely by reason of Section 162, I.R.C. (other than rents and reimbursed amounts with respect to such unit) is less than fifteen percent of the gross rental income produced by the unit; or (2) Even if the lessor's deductions under Section 162 are fifteen percent or more of the rental income, if the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income. Under current investment interest rules, noncorporate taxpayers cannot deduct in any taxable year more than \$10,000 of investment interest plus the taxpayer's net investment income and "out-of-pocket" expenses incurred in connection with "net lease" property. The disallowed investment interest can be carried over indefinitely to succeeding taxable years. See Section 163(d), I.R.C.

<sup>25</sup>Prop. Reg. § 1.280A-3(d)(3) (1983).

If the unit is limited personal usage property, the allocable portion of each category may be deducted without limitation.<sup>26</sup> If the unit is *de minimis* rental, the total amount of category (1) expenses are deductible on Schedule A but no other deductions are allowed.<sup>27</sup> If the unit is residence usage property, the allocable portion of category (2) is allowable only to the extent that gross rental income exceeds the deduction under category (1) and the allowable portion of category (3) is allowable only to the extent the gross rental income exceeds the deductions under categories (1) and (2).<sup>28</sup> Gross rental income is the gross receipts from the rental of the unit reduced by expenditures necessary to obtain tenants for the unit, such as advertising expenses.<sup>29</sup> All other expenses associated with the unit fall into the three previous categories.<sup>30</sup>

<sup>26</sup>Enis, *supra* note 20, at 56.

<sup>27</sup>Prop. Reg. § 1.280A-3(b) (1983).

<sup>28</sup>*Id.*

<sup>29</sup>Prop. Reg. § 1.280A-3(d)(2) (1983).

<sup>30</sup>*Id.* The following is an example of the order of deductions when personal use of the unit qualifies it as residence usage property:

<u>Allocation of Days:</u>	<u>Total (100%)</u>	<u>Personal Use* (20%)</u>	<u>Rental Use (80%)</u>
Personal Days	73	73	—
Rental Days	292	—	292
Total	<u>365</u>	<u>73</u>	<u>292</u>
<u>Financial Data:</u>			
Rental Income	\$10,000	—	\$10,000
Mortgage Interest	(4,000)	\$ (800)	\$ (3,200)
Real Estate Taxes	(1,000)	(200)	(800)
Insurance	(2,000)	(400)	(1,600)
Depreciation	(10,000)	(2,000)	(8,000)
Total	<u>\$ (7,000)</u>	<u>\$(3,400)</u>	<u>\$ (3,600)</u>

\*qualifies as residence usage under 280A since personal use days exceed the greater of 14 days or 10% of the number of days rented at fair market rental.

#### SCHEDULE E RENTAL INCOME (LOSS):

Gross rental income	\$10,000
Less category #1 deductions:	
Mortgage Interest	(3,200)
Real Estate Taxes	<u>(800)</u>
Subtotal	6,000
Less category #2 deductions:	
Insurance	<u>(1,600)</u>
Subtotal	4,400
Less category #3 deductions:	
Depreciation	<u>(4,400)**</u>
Rental Income (Loss)	<u><u>-0-</u></u>

#### SCHEDULE A ITEMIZED DEDUCTIONS:

Mortgage Interest	\$ 800
Real Estate Taxes	<u>200</u>
Total	<u><u>\$ 1,000</u></u>

\*\*limited to remaining gross rental income since unit is treated as residence usage under 280A.

## FURTHER ANALYSIS OF PERSONAL USE

Since the key to the application of 280A is the taxpayer's personal use of the unit, advance planning will enable the taxpayer to best utilize the unit for both personal and business purposes.<sup>31</sup> As previously stated, the amount of a taxpayer's personal use causes the unit to fall into one of three categories:

(1) Limited Personal Usage — Generally, rental losses may be deducted on Schedule E because the taxpayer used the unit for personal purposes for a number of days which was less than the greater of 14 days or 10% of the number of days during which the unit was rented at fair market rental (14 day/10% test);

(2) Residence Usage — Rental expenses are deductible to the extent of gross rental income and no rental loss may be deducted on Schedule E; and

(3) *De Minimis* Rental — Gross rental income and expense are not to be reported on Schedule E and all category (1) expenses are allocated to Schedule A because the taxpayer rented the unit for less than 15 days.<sup>32</sup>

The impact of 280A results from the definition of "personal use" of the unit.<sup>33</sup> A taxpayer is considered to have used the unit for personal purposes on any day, or part of a day, if any portion of the unit is used:

(1). for personal purposes by the taxpayer or any other person having an interest in the unit;

(2). by a sibling, spouse, ancestor or lineal descendant of the taxpayer or any other owner;

(3). by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit for a period of time regardless of whether rent is charged for the other unit and regardless of the length of time that the taxpayer uses the other unit; or

(4). by any individual to whom less than a fair market rental is charged.<sup>34</sup>

The original Proposed Treasury Decision issued August 7, 1980 stipulated that rental to a member of the taxpayer's family constituted personal use by the taxpayer regardless of whether a fair market rental was paid by the family member.<sup>35</sup> In 1980, congressional dissatisfaction with some effects of these

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<sup>31</sup>Dalton, *supra* note 1, at 349.

<sup>32</sup>Enis, *supra* note 20, at 53-56.

<sup>33</sup>Dalton, *supra* note 1, at 348, 349.

<sup>34</sup>I.R.C. § 280A(d)(2) (1986). In Rev. Rul. 80-55, 1980-1 C.B. 65, taxpayer A rented his house to taxpayer B at fair market rental under an arrangement in which B also rented his house to A at fair market rental. Despite charging fair market rental, the IRS ruled that A's use of B's house constituted personal use of B's house by B and B's use of A's house constituted personal use of A's house by A.

<sup>35</sup>See Treas. Reg. § 1.280A-1(e)(2), 45 Fed. Reg. 52,399 (1980).

family attribution rules resulted in a joint resolution prohibiting the appropriation of funds for fiscal year 1981 for implementing or enforcing any regulation or ruling under 280A relating to the rental of a unit to a family member.<sup>36</sup> In 1981, effective for taxable years beginning after December 31, 1975, Congress amended 280A to provide that a taxpayer will not be treated as using the unit for personal purposes if the unit is rented at a fair market rent to *any person* for use as a principal residence.<sup>37</sup> Therefore, the Proposed Treasury Decision was amended July 21, 1983 and now the fair market rental of a unit to a member of the taxpayer's family or the family of a co-owner for use as personal residence is not personal use by the taxpayer.<sup>38</sup>

A fair market rental is determined through several factors, such as comparable rentals in the area and whether substantial gifts were made by the taxpayer to family members at the time of the lease or thereafter.<sup>39</sup>

In *Bindseil*, the taxpayer had an understanding that his parents would make improvements and repairs to a house in return for a lower than fair market rent.<sup>40</sup> The key issue was whether the rent was a fair market rent when the value of the personal services was considered.<sup>41</sup> An expert Internal Revenue Service (IRS) witness used "comparables" to show that, even after increasing the actual rent received with the value of the repairs and improvements, the rent was less than fair market rent.<sup>42</sup> The Tax Court therefore held that 280A applied and disallowed the deductions for other than interest and taxes.<sup>43</sup> The result of this decision was a loss of \$3,500 in deductions for repairs, insurance and depreciation because the taxpayer had discounted the rent to his parents by approximately \$790.<sup>44</sup> The decision highlights the tax exposure under 280A with rent for less than fair market; it is not limited to the difference between fair market rent and the actual rent received but can be as much as the total of all deductions relating to rental other than interest, taxes, and casualty losses.<sup>45</sup>

If the taxpayer is a co-owner of a unit, he or she will be treated as renting

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<sup>36</sup>Announcement 80-151, I.R.B. 1980-47, 21, regarding Joint Resolution 610, Section 123.

<sup>37</sup>I.R.C. § 280A(d)(3)(A) (1986).

<sup>38</sup>Research Institute of America, Inc., RIA REAL ESTATE COORDINATOR, ¶ 66,913 (1985).

<sup>39</sup>Summary of H.R. 5159 by Staff of Joint Comm. Tax., 12/2/81, p. 12. Because fair rental is determined by taking into account gifts by the taxpayer to the tenant, 280A cannot be circumvented by providing for fair market rental with the landlord returning part of the rent as a gift.

<sup>40</sup>*Bindseil v. Commissioner*, 83 T.C.M. (P-H) 1695 (1983).

<sup>41</sup>*Id.*

<sup>42</sup>*Id.*

<sup>43</sup>*Id.* If less than fair market rental is charged, the taxpayer cannot avoid 280A by asserting Section 183, I.R.C. relating to activities not engaged in for profit. Under Section 280A(f)(3) the limitation provisions of 280A override the hobby loss provisions of Section 183 and therefore the taxpayer cannot preserve the disallowed deductions by arguing that the rental activity was engaged in to make an overall profit.

<sup>44</sup>*Id.*

<sup>45</sup>I.R.C. § 280A(d)(2) (1986).

the unit at fair market rental if the taxpayer charges an amount equal to the fair market rental of the entire unit multiplied by that taxpayer's fractional interest in the unit.<sup>46</sup>

An exception to the personal use of a unit under 280A exists where the principal purpose of the use of the unit is to perform repair or maintenance work.<sup>47</sup> The determination of whether the principal purpose is for repair work is based on facts and circumstances of each case, but specific factors to consider include:

- (1). The amount of time devoted to the repair work;
- (2). The frequency of the use of the unit for repairs during the year; and
- (3). The presence and activities of companions.<sup>48</sup>

The taxpayer must work in repairing a unit on a substantially full-time basis each day in order to exclude the day from being considered as a personal use day.<sup>49</sup> It is not necessary that all persons present work on the unit on a substantially full-time basis.<sup>50</sup> The taxpayer is not expected to perform any repair work on days of arrival and departure from the unit, assuming he or she is present only a portion of such days.<sup>51</sup>

A unit is not treated as rented at fair market rental for any day in which it is used for personal purposes.<sup>52</sup> Further, if a taxpayer is present at the unit and uses it for personal purposes on any days for which it is also rented, such days are counted as personal days.<sup>53</sup> However, the Tax Court has held that personal use of one unit of a duplex does not constitute personal use of the other unit because the building consists of two separate and distinct units.<sup>54</sup>

For purposes of determining whether a unit is in the category of limited personal usage or residence usage, Congress added a special rule regarding conversion of a unit formerly used by the taxpayer as his principal residence.<sup>55</sup> If

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<sup>46</sup>Prop. Reg. § 1.280A-1(g)(2) (1983) illustrates the application of the fractional interest rule as follows: A and B each own 1/2 interest in a unit for which fair market rental is \$100/month. C rents the unit, for which A charges \$50 and B charges \$20. A is treated as renting at fair market rental ( $\$100 \times 50\% = \$50$ ).

<sup>47</sup>Prop. Reg. § 1.280A-1(e)(6) (1983).

<sup>48</sup>Prop. Reg. § 1.280A-1(e)(7) (1983).

<sup>49</sup>Amentends to the Internal Revenue Code of 1954, Pub. L. No. 97-119, § 113(a)-(d), 95 Stat. 1635, 1641.42, (1981).

<sup>50</sup>Dalton, *supra* note 1, at 348, 350. However, as indicated by examples in Prop. Reg. § 1.280A-1(e)(7) (1983), the other persons should spend at least a few hours each day in repair work.

<sup>51</sup>Prop. Reg. § 1.280A-1(d)(1) (1983).

<sup>52</sup>Prop. Reg. § 1.280A-1(e)(2) (1983). However, a brief visit during which the taxpayer is a guest of the occupant of the unit is not considered personal use by the taxpayer.

<sup>53</sup>Prop. Reg. § 1.280A-1(e)(4) (1983). Note, however, that the use of the unit for personal purposes is taken into account for all other purposes of 280A (e.g. allocation of expenses).

<sup>54</sup>Gorod v. Commissioner, 42 T.C.M. (CCH) 1569 (1981).

<sup>55</sup>I.R.C. § 280A(d)(4) (1986).

the taxpayer's principal residence is converted to rental use for a "qualified rental period," the number of days that the home served as the principal residence before the conversion will not count as personal days during the qualified rental period.<sup>56</sup> The period begins the date the property is rented or held out for rent and ends on the earlier of twelve months later or when the home is sold or exchanged.<sup>57</sup>

### ANALYSIS OF RENTAL USE

Section 280A applies to any unit such as a house or separate section of a house, apartment, boat, or similar property which provides basic living accommodations such as sleeping, toilet, and cooking facilities.<sup>58</sup> However, renting one bedroom in a house may not constitute renting a separate dwelling unit.<sup>59</sup> A unit used exclusively as a hotel or motel also does not apply under 280A but the IRS has indicated that *any* personal use will prevent rental property from qualifying for the hotel/motel exception and will subject the unit to the provisions of 280A.<sup>60</sup>

Because of the 1983 amendment to the Proposed Treasury Decision, the number of days that a unit is rented to a relative is counted as rental use instead of personal use if the relative pays a fair market rental and uses the home as a principal residence.<sup>61</sup> This same amendment also applies to the rental of a home to a person who has an equity interest in the property as a party to a

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<sup>56</sup>*Id.* While the exception for personal use before a qualified rental period may allow the taxpayer to avoid 280A limitations, whether he or she will be permitted to deduct expenses in excess of rental income during the qualified rental period preceding the sale of the residence will depend upon if he or she can establish the primary motive in renting the unit was to earn a profit, as determined under Section 183, I.R.C. In *Bolaris v. Commissioner*, 81 T.C. 840 (1983), the Tax Court held the temporary rental of a residence prior to sale does not generally constitute an activity engaged in to earn a profit. Therefore, under Section 183, the taxpayer was not permitted to deduct expenses associated with the rental of the property in excess of gross rental income. Even if the taxpayer is successful in establishing the rental activity is for profit under Section 183, under *Bolaris* the residence may then no longer qualify for the nonrecognition provisions of Section 1034, I.R.C. Therefore, the taxpayer should carefully weigh the benefits of Sections 183 and 1034 when renting a residence prior to sale.

<sup>57</sup>Prop. Reg. § 1.280A-3(c)(1) (1983).

<sup>58</sup>Prop. Reg. § 1.280A-1(c)(1) (1983). Omission of additional amenities as well as disqualification of property as a unit under local law will not prevent its classification as a unit under 280A. *Haberkorn v. Commissioner*, 75 TC 259 (1980).

<sup>59</sup>In IRS Letter Ruling 8303007, a taxpayer owned a four bedroom house, used one for himself and rented the other three to unrelated tenants. All parties had access to the common areas of the house. In applying 280A, the IRS treated that four bedrooms and common areas as part of a single unit, rather than as more than one unit within the meaning of 280A(f)(1)(A).

<sup>60</sup>IRS Letter Ruling 8303007. In order to fall within the hotel/motel exception, Prop. Reg. § 1.280A-1(c)(2) (1983) provides that the property must be regularly available for occupancy and the taxpayer must not use the property as a *residence* during the year. More recently, the IRS in Letter Ruling 8518003 has indicated, contrary to Prop. Reg. § 1.280A-1(c)(2) (1983), that *any* personal use will prevent rental property from qualifying for the hotel/motel exception and will subject the unit to 280A limitations. In fact, the ruling makes no reference to the proposed regulations. In addition, the Letter Ruling, citing *Fine v. U.S.*, 493 F.Supp. 540 (N.D. Ill. 1980), *aff'd*, 647 F.2d 763 (7th Cir. 1981), implies that a condominium unit qualifies for the hotel/motel exception only if the entire condominium complex is operated as a hotel.

<sup>61</sup>I.R.C. § 280A(d)(3) (1986).

"shared equity financing agreement."<sup>62</sup>

For purposes of determining total rental days, the number of rental days includes any day for which the unit is rented for a fair market rental without any personal use by the taxpayer.<sup>63</sup> The period during which the unit is merely held out for rent is not considered in determining the number of rental days for a taxable year.<sup>64</sup>

#### ANALYSIS OF ALLOCATING RENTAL AND PERSONAL EXPENSES

The extent to which the expenses of operating a unit are allocated to the rental activity depends upon the number of personal use days and the number of rental use days.<sup>65</sup>

When the total of the rental and personal days does not equal 365 days, the allocation formula becomes the subject of much confusion and controversy.<sup>66</sup> The IRS and the Proposed Treasury Decision (collectively referred to as "Treasury Decision") take the position that all expenses of maintaining a unit must be allocated to the rental use in proportion to the number of rental days usage to the total number of days usage.<sup>67</sup> Days during which the unit is used for repair and maintenance and days in which the unit is merely available for rent are disregarded in this calculation.<sup>68</sup>

However, the Treasury Decision as applied to category (1) (i.e. interest, taxes, and casualty losses) was not followed by the Ninth Circuit in *Bolton v. Commissioner*.<sup>69</sup> The court held that interest and taxes incurred in connection with a unit should be allocated to the rental activity in relation to the total number of days in the year.<sup>70</sup> Because that portion of category (1) expenses are also deductible on Schedule A, the method of allocating in *Bolton* increases the potential deductions available to the taxpayer.<sup>71</sup> According to *Bolton*, interest,

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<sup>62</sup>Enis, *supra* note 20, at 58. Generally, a shared equity financing agreement is one where at least two persons obtain an undivided interest in property for a period of greater than fifty years and at least one party has the option to rent the dwelling as a principal residence while paying rent to the other parties.

<sup>63</sup>Letter Ruling 8130008. Therefore, a taxpayer who rented a unit to her sister for an entire year at less than fair market rental was deemed to have used the unit for personal purposes every day that her sister rented it and none of the expenses were attributable to rental of the unit. The taxpayer could deduct only interest and taxes on Schedule A.

<sup>64</sup>Tax Reform Act of 1976, Pub. L. No. 94-55, § 601, 90 Stat. 1520, 1569-72 (1976).

<sup>65</sup>Enis, *supra* note 20, at 55.

<sup>66</sup>See, e.g., Lathen, *Bolton: IRS 'Bizarre' on Section 280A(e)*, 60 TAXES 237 (1982); Kerr, *The Rental of Personal Residences: Implications of Section 280A*, J. REAL EST. TAX. 139 (1980).

<sup>67</sup>Prop. Reg. § 1.280A-3(d)(3) (1983) and Prop. Reg. § 1.280A-3(c)(4) (1983). See *Bolton v. Commissioner*, 694 F.2d 556 (9th Cir. 1982), *aff'g*, 77 T.C. 104 (1981).

<sup>68</sup>Prop. Reg. § 1.280A-3(c)(1) (1983).

<sup>69</sup>*Bolton*, 694 F.2d 556 (9th Cir. 1982), *aff'g*, 77 T.C. 104 (1981).

<sup>70</sup>*Id.* at 563.

<sup>71</sup>I.R.C. §§ 163, 164, and 165 (1986). With a smaller portion of interest, taxes, and casualty losses allocated to the rental use under the *Bolton* method, a greater amount of such expenses may be deducted by the taxpayer on Schedule A.

taxes, and casualty losses are expenses that relate to the entire year and should be allocated on that basis.<sup>72</sup> Nevertheless, the Treasury Decision's position is still applicable to categories (2) and (3) as deductions related to actual use.<sup>73</sup>

The *Bolton* holding is a victory for the taxpayer with residence usage who itemizes deductions on Schedule A of his or her Federal income tax return. A smaller proportion of category (1) expenses allocated against rental income will result in the remaining category (1) expenses being deducted as itemized deductions and leaving more gross rental income to absorb the allocable category (2) and (3) expenses.

Under this example, if the taxpayer itemizes deductions, he or she may deduct \$450 under the method used in the Treasury Decision as compared to \$1,602 under the *Bolton* method.

<sup>72</sup>*Bolton*, 694 F.2d at 563.

<sup>73</sup>*Id.* An example of the concepts is: Taxpayer owns the unit for the whole year and rents it at a fair market rental for 170 days and uses the unit for personal purposes for 30 days. The property is either used for repairs and maintenance or held out for rent the remainder of the year. The taxpayer has residence usage since he or she exceeded the 14 day/10% test and can therefore only take allocable deductions up to gross rental income. The following illustrates the revenue and expenses for the year along with a comparison of the Treasury Decision allocation method to the *Bolton* allocation method:

**SCHEDULE E RENTAL INCOME (LOSS):**

	<b>TOTAL</b>	<b>TREASURY DECISION</b>	<b>BOLTON HOLDING</b>
Gross receipts	\$4,500		
Less: advertising	(300)		
Gross rental income	<u>4,200</u>	<u>\$4,200</u>	<u>\$ 4,200</u>
<b>Category (1) expenses:</b>			
Mortgage interest	(2,000)	(1,700)*	(932)**
Real estate taxes	(1,000)	(850)*	(466)**
Total category (1)	<u>(3,000)</u>	<u>(2,550)</u>	<u>(1,398)</u>
Limit on further deductions		\$1,650	2,802
<b>Category (2) expenses:</b>			
Insurance	(500)	(425)*	(425)*
Utilities	(800)	(680)*	(680)*
Repairs	(400)	(340)*	(340)*
Total category (2)	<u>(1,700)</u>	<u>(1,445)</u>	<u>(1,445)</u>
Limit on further deductions		205	1,357
<b>Category (3) expenses:</b>			
Depreciation —	(6,000)		
Amount allowable:		(205)	(1,357)
Total category (3)	<u>(6,000)</u>	<u>(205)</u>	<u>(1,357)</u>
Schedule E Rental income (loss):		<u>-0-</u>	<u>-0-</u>

**SCHEDULE A ITEMIZED DEDUCTIONS:**

Mortgage interest	\$ (300)	\$(1,068)
Real estate taxes	(150)	(534)
Schedule A itemized deductions	<u>\$ (450)***</u>	<u>\$(1,602)****</u>

**KEY:**

- \* — Rental portion =  $170/200 = 85.0\%$
- \*\* — Rental portion =  $170/365 = 46.6\%$
- \*\*\* — (3,000 - 2,550)
- \*\*\*\* — (3,000 - 1,398)

Subsequent to the Ninth Circuit agreeing with the Tax Court in *Bolton*, the Tenth Circuit has also concurred with the Tax Court and Ninth Circuit and has held that the allocation under the Proposed Regulations was contrary to the statutory language and the legislative intent.<sup>74</sup>

#### RENTAL POOLS AND TIME SHARING ARRANGEMENTS

The limitations of 280A also apply to time sharing units and to units participating in a rental pool.<sup>75</sup>

##### *Rental Pool:*

A rental pool is an arrangement in which two or more units are made available for rental by their owners who agree to share rental income from the units without regard to the actual use of the units.<sup>76</sup> Each participant in the rental pool must include in gross rental income all amounts generated from their participation in the rental pool.<sup>77</sup>

The application of 280A is generally based upon *actual* days of use by the taxpayer and the *actual* number of rental days of his or her own unit at fair market rental; its availability for rental through the pool does not constitute rental days.<sup>78</sup> In *Byers v. Commissioner*, the taxpayer owned condominium units in a resort hotel which were made available for rent through a rental pool arrangement.<sup>79</sup> The Tax Court held that mere participation in a rental pool is not considered in determining the number of rental days for a taxable year.<sup>80</sup>

If all taxpayers in the rental pool elect, they may use an averaging formula to determine the number of days of rental use.<sup>81</sup> The determination of the number of days of personal use and other use will continue to be based on actual circumstances.<sup>82</sup> The aggregate number of days that units in the rental pool are rented at a fair market rental is apportioned among the units in the pool according to the ratio of the number of participation days of a particular

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<sup>74</sup>*McKinney v. Commissioner*, 732 F.2d 414 (10th Cir. 1983). However, the allocation of interest, taxes, and casualty losses is not completely clear despite the holdings in *Bolton* and *McKinney*. Until the IRS announces a change in position, a taxpayer needs to be aware of the possibility that the IRS will challenge any allocation of interest, taxes, and casualty losses that is contrary to the Regulations.

<sup>75</sup>Fudeman, *supra* note 15, at 46, 50.

<sup>76</sup>Prop. Reg. § 1.280A-3(e)(2) (1983).

<sup>77</sup>Prop. Reg. § 1.280A-3(e)(3) (1983).

<sup>78</sup>Prop. Reg. § 1.280A-3(e)(4)(ii), (iii) (1983). The Proposed Regulation imposes a documentation requirement by providing that the rental agency managing the pool furnish the taxpayer a written statement indicating the number of days of fair market rental and the number of days of other use.

<sup>79</sup>*Byers v. Commissioner*, 82 T.C. 919 (1984).

<sup>80</sup>*Id.* at 927.

<sup>81</sup>Prop. Reg. § 1.280A-3(e)(5)(i) (1983). Each participant in the pool must execute an irrevocable consent and the consent may apply to more than one pool season.

<sup>82</sup>*Id.*

unit over the aggregate number of participation days of all units.<sup>83</sup> The number of rental days allocated to the unit is then compared to the actual days of personal use by the taxpayer to determine the 280A limitations.<sup>84</sup>

In planning for participation in a rental pool, a taxpayer should be aware that periods of time the unit is entered in the pool but not rented does not constitute rental days even though reduced rental fees ("occupancy fees") may have been received.<sup>85</sup> Occupancy fees are, however, included in gross rental income.<sup>86</sup> In *Fine v. U.S.*, the taxpayer made his unit available in a rental pool for 333 days.<sup>87</sup> Of the 333-day period, the unit was actually rented at a fair market rental for 149 days and was only available for rent the remaining 184 days.<sup>88</sup> Though the taxpayer received an occupancy fee for those days, the court held that the 184-day period was not includible in the number of rental days because the occupancy fee was less than a fair market rental rate.<sup>89</sup>

### *Time-sharing:*

A time-sharing arrangement is where two or more persons with interests in a unit agree to exercise control over the unit for different periods of time during the year.<sup>90</sup> Investors in the time-sharing arrangements must *aggregate* the number of personal days and rental days by all owners to see if the limitations imposed on deductions under 280A will apply to all owners.<sup>91</sup> Because of this usually substantial amount of personal use attributed to an owner of time-sharing rights, taxpayers generally purchase time-sharing units for personal pleasure rather than as rental property.<sup>92</sup>

## TAX PLANNING IDEAS

### *Rental Property for Parents of College Students:*

The amended 280A provides that a taxpayer is not treated as using a unit

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<sup>83</sup> *Id.* A "participation day" of a unit is a day for which the unit is entered into the rental pool. For example, if the aggregate number of fair market rental days is 300, the number of participation days for the taxpayer's unit is 80, and the aggregate participation days is 480, the number of days of fair market rental to allocate to the taxpayer's unit is:  $80/480 \times 300 = 50$ .

<sup>84</sup> *Id.*

<sup>85</sup> *Fine v. U.S.*, 647 F.2d 763 (7th Cir. 1981).

<sup>86</sup> Prop. Reg. § 1.280A-3(e)(3) (1983).

<sup>87</sup> *Fine*, 647 F.2d at 763.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> Dalton, *supra* note 1, at 348, 352.

<sup>91</sup> Prop. Reg. § 1.280A-3(f)(3) (1983).

<sup>92</sup> Fudeman, *How to Minimize the Section 280A Limitations on Rental Losses*, The Practical Accountant, December 1984, at 45, 50. Given the economics of time-sharing arrangements and the requirement of aggregating all participants, it would also be difficult under Section 183, I.R.C. for a taxpayer to prove a profit motive even if he or she did rent the unit for part of the year. See Vogel, *The Tax Consequences of Time-Sharing*, 10 J. REAL EST. TAX. 323 (1984).

for personal purposes where the unit is rented to any person at a fair market rental for use as that person's principal residence.<sup>93</sup> The amendment has promoted the development of a new market in real estate — investment in units by parents for rental to their children in college.<sup>94</sup> If a taxpayer buys an off-campus unit in the town in which his or her child attends school, the child can both live in the unit and act as the building manager. The taxpayer, in turn, can collect rent from the other student-tenants and deduct expenses associated with the rental activities on Schedule E. Since 280A requires fair market rental, the taxpayer should charge the child at least a fair market rental less the value of the rental management services provided by the child.<sup>95</sup> Reasonable costs of trips in connection with inspecting the rental property should be deductible, and visiting a child during the trip is an added bonus.<sup>96</sup> A taxpayer considering this type of investment faces two hurdles: establishing whether the unit constitutes the personal residence of the child, which is generally a facts and circumstances test; and establishing whether a fair market rental is charged.<sup>97</sup>

### *De Minimis Rental:*

A taxpayer with a vacation home purchased mainly for personal use should consider renting the unit for 14 days each year. If the unit is rented for only 14 days, it is *de minimis* rental and gross rental revenue is ignored for Federal tax reporting purposes and all category (1) expenses are Schedule A deductions.<sup>98</sup> A taxpayer may even wish to take advantage of this provision by renting his or her personal residence at times of high demand, such as when a big sports event is in town.<sup>99</sup>

### *Rental Property "Above the Line" Deductions:*

When property is classified as limited personal usage, expenses must be allocated between rental days and personal days, but those expenses allocated to

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<sup>93</sup>I.R.C. § 280A(d) (1986).

<sup>94</sup>Dalton, *supra* note 1, 348, 350-51. *Maximizing After-tax Return on Vacation Property Rental Requires Special Care*, Taxation For Accountants, June 1984, at 348, 350-51.

<sup>95</sup>I.R.C. § 280A(d) (1986).

<sup>96</sup>Deloitte Haskins & Sells, *Personal Business Thoughts — A Real Estate Tax Shelter for Parents of College Students*, THE WEEK IN REVIEW 84-4, January 1984, at 7, 7.

<sup>97</sup>Dalton, *supra* note 1, at 348, 351.

<sup>98</sup>Prop. Reg. § 1.280A-3(b) (1983).

<sup>99</sup>Enis, *supra* note 20, at 62.

rental days may exceed gross rental income on Schedule E.<sup>100</sup> In this classification, a taxpayer *cannot* generate more deductions by using the *Bolton* method over the Treasury Decision method.

While the total Schedule E and Schedule A deductions are the same under either method, a greater amount of deductions are allocated to Schedule A under the *Bolton* method. These two methods allow great flexibility in where to allocate expenses, as Schedule E is an "above-the-line" deduction which determines adjusted gross income on Federal Form 1040 while Schedule A is a "below-the-line" deduction which is a deduction from adjusted gross income to determine taxable income. If a taxpayer is in a state which taxes a resident based on the federal adjusted gross income, it may be beneficial to use the Treasury Decision method in order to allocate more expenses to Schedule E. Since Schedule E reduces Federal adjusted gross income, a lower base will be carried

<sup>100</sup>*Id.* at 56. See *supra* note 2. As an example:

**SCHEDULE E RENTAL INCOME (LOSS):**

	<b><u>TOTAL</u></b>	<b><u>TREASURY DECISION</u></b>	<b><u>BOLTON METHOD</u></b>
Gross receipts	4,500		
Less advertising	(300)		
Gross rental income	<u>4,200</u>	<u>4,200</u>	<u>4,200</u>
<b><u>Category (1) expenses:</u></b>			
Mortgage interest	(2,000)	(1,700)*	(932)**
Real estate taxes	(1,000)	(850)*	(466)**
Total category (1)	<u>(3,000)</u>	<u>(2,550)</u>	<u>(1,398)</u>
Subtotal		1,650	2,802
<b><u>Category (2) expenses:</u></b>			
Insurance	(500)	(425)*	(425)*
Utilities	(800)	(680)*	(680)*
Repairs	(400)	(340)*	(340)*
Total category (2)	<u>(1,700)</u>	<u>(1,445)</u>	<u>(1,445)</u>
Subtotal		205	1,357
<b><u>Category (3) expenses:</u></b>			
Depreciation —	(6,000)	(5,100)	(5,100)
Total category (3)	<u>(6,000)</u>	<u>(5,100)</u>	<u>(5,100)</u>
SCHEDULE E RENTAL INCOME (LOSS)		<u><u>\$(4,895)</u></u>	<u><u>\$(3,743)</u></u>

**SCHEDULE A ITEMIZED:**

Mortgage interest	\$ (300)	\$(1,068)
Real estate taxes	(150)	(534)
Schedule A itemized deductions	<u>\$ (450)***</u>	<u>\$(1,602)****</u>
TOTAL SCHEDULE E AND A	<u><u>\$(5,345)</u></u>	<u><u>\$(5,345)</u></u>

**KEY:**

- \* — Rental portion = 170 rental/200 rental & personal = 85.0%
- \*\* — Rental portion = 170 rental/365 days = 46.6%
- \*\*\* — (3,000 - 2,550)
- \*\*\*\* — (3,000 - 1,398)

to the state return to determine state income tax. Other instances, such as excessive charitable contributions which are limited to a percentage of adjusted gross income, may warrant the use of the *Bolton* method to allocate more expenses to Schedule A in order to have a higher federal adjusted gross income.

### *Shared Equity Financing Arrangements:*

Generally, a shared equity financing arrangement will be entered into by two persons.<sup>101</sup> One co-owner seeks a place to reside in which he has an ownership interest in the unit while the other co-owner seeks the cash flow and tax benefits of investing in real estate without the risk of vacancy and management costs.<sup>102</sup> Typically, the non-occupying co-owner will provide a major portion of the downpayment while the other co-owner pays a fair market rental to reside in the unit.<sup>103</sup> However, the fair market rental may take into account the interest of the occupying co-owner and thus a 50% investor's fair market rental may be one-half of fair market rates for comparable housing in the area.<sup>104</sup> While allocation of operating expenses between co-owners is not addressed in the proposed regulations, the Tax Court has held that the allocation must be on the basis of their proportionate interests in the unit.<sup>105</sup> While the deduction of operating expenses may be limited to each co-owner's proportionate interest in the unit, the deduction for interest and taxes is generally based upon amounts actually paid and thus these expenses do not have to be proportionately split.<sup>106</sup>

## THE IMPACT OF THE TAX REFORM BILL

In May 1985, the President presented a tax reform plan which has since been reshaped by the House Ways and Means Committee and passed by the House of Representatives ("House").<sup>107</sup> The bill approved by the House is similar to the President's plan, but one issue relating directly to the vacation home and rental market has been changed and improved upon over the President's proposal.<sup>108</sup>

Under current law, the only limitation imposed on the deductibility of interest is imposed on "investment interest."<sup>109</sup> The President's proposal sought

<sup>101</sup>See *supra* note 62.

<sup>102</sup>Dalton, *supra* note 1, at 348, 351.

<sup>103</sup>*Id.*

<sup>104</sup>Prop. Reg. § 1.280A-1(g) (1983). Where there is more than one non-occupying owner, each need not charge fair market rental. However, those who do not charge fair market rental will be deemed to have used the unit for personal purposes and 280A limitations apply.

<sup>105</sup>Estate of Boyd v. Commissioner, 28 T.C. 564 (1957).

<sup>106</sup>Rev. Rul. 71-268, 1971-1 C.B. 58.

<sup>107</sup>H.R. Rep. No. 426, 99th Cong., 1st Sess. 2, Tax Reform Act of 1985 (1985).

<sup>108</sup>*Id.* at 297.

<sup>109</sup>See *supra* note 24 and I.R.C. § 163(d) (1986).

to expand the definition of interest subject to limitation to include all interest not incurred in connection with a trade or business, other than interest on debts secured by the taxpayer's *principal* residence.<sup>110</sup> Under the House bill, the definition of interest subject to limitation is expanded to include all interest not incurred in connection with a trade or business, other than interest on debts secured by the taxpayer's principal residence *and one other residence of the taxpayer*.<sup>111</sup> While the other aspects of the House bill may prove to be somewhat adverse to the vacation home and rental market, this important addition allows all taxpayers to at least retain full deductibility of interest on their principal residence and one other vacation home or rental property.<sup>112</sup>

#### CONCLUSION

280A provides complex rules for determining whether a unit will be deemed "residence usage," "limited personal usage," or "*de minimis* rental." However, an understanding of the rules, regulations, and holdings under 280A offer detailed guidance on how to best utilize a unit for both personal and business use. Advance planning will maximize both the personal use of the unit while also retaining the unit's tax benefits.

CRAIG TELLERD

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<sup>110</sup>DELOITTE HASKINS & SELLS, *The President's Tax Reform Plan*, 12 (1985).

<sup>111</sup>H.R. Rep. No. 426, 99th Cong., 1st Sess. 132, Tax Reform Act of 1985 (1985).

<sup>112</sup>*Id.*

