Memo

To: Clients and Friends

From: Capital Enhancement LLC

Subject: Tax Treatment of Home Rentals

The purpose of this memo is to outline potential tax treatments of home rentals, depending on how much you wish to use the home personally. We will mainly contrast a pure business rental with rentals of "vacation" homes where there is significant personal use. The tax law defines significant personal use as the greater of 14 days or 10% of the days rented.

I. THE TWO WEEK RENTAL EXCEPTION

This is the simplest tax treatment of rental homes. Should you rent a home for fourteen days or less each year, the rental is incidental and you can exclude that rent from income.

II. RENTAL PROPERTY TREATMENT/PASSIVE LOSS RULES

If you rent a home more than 14 days and there is no personal use, or personal use is less than 14 days or 10% of the days rented, your property is a rental property for tax purposes and has its own profit and loss. That profit and loss is reported on Schedule E of your tax return.

Personal Use of a Rental Property

If you rent the property and use it personally, you must make an allocation between the personal and business expenses. For example, if you rented the home 90 days per year and used it 10 days personally, 90% of the expenses (mortgage interest, real estate taxes, depreciation, and any other expenses) would be able to offset the rent (less rental commissions if you use an agent) on Schedule E, and the personal part of the interest and taxes could be deducted as an itemized deduction.

Tax Treatment of the Rental Profit and Loss on Schedule E

The rental part of the property has its own separate profit and loss statement. Because of depreciation, our experience is that most rentals produce a tax loss each year. The question is what happens to that loss?

If your income is below $150,000 that year and you "actively" participate in the renting (you are involved and are not completely an absentee landlord), you can deduct up to $25,000 each year of all your rental losses. Any losses in excess of that generally get carried forward under the passive loss rules discussed below.

The Passive Loss Rules

Rentals, by definition, are generally considered passive. You carry forward passive losses until you have passive income to offset the losses, or you sell that property. At sale, all carried forward losses from that property are deductible, even if they exceed your passive income.

If your income is more than $150,000, you have to carry forward your passive losses. You are not allowed to deduct current year's passive losses against other income like wages.

Exceptions to the Passive Loss Rules

There are two notable exceptions that allow you to deduct current year rental losses against other current year income such as wages, pensions, interest and dividends. The first is that you can deduct losses if you are a "real estate professional". This generally means you spend at least 750 hours a year on real estate activities, and more than half of your professional time as well.

The second exception is if the property qualifies as a "short term rental". Typically, we see this with beach homes where the rental period is 7 days or less. You have to have significant involvement in the rentals if you wish to qualify for this treatment.

If you believe you may qualify for either exception, please speak with us, as there are a number of nuances.

A Note About Depreciation

Depreciation is a "paper" expense allowed against your rental income. It is not allowed against the value of the land but is allowed against the value of the physical dwelling – you allocate original cost of the property between land and dwelling. Most residential properties are depreciated over 27.5 years, meaning the annual depreciation deduction is roughly 3.5% of the cost of the dwelling.

For example, assume you started renting a home that cost $200,000. Half of the cost is attributable to the land, and half ($100,000) to the dwelling. The annual depreciation deduction would be about $3,500, and this could be used to offset rent. Your $200,000 cost basis in the property is reduced by $3,500 per year.

III. VACATION HOME TREATMENT

If you personally use the property more than the greater of 14 days or 10% of the days rented, the property is considered a vacation home from a tax standpoint. Similar to a

rental property, the rental portion is reported on Schedule E, offset by a portion of the various expenses. Unlike a rental property, rental losses from a vacation home are generally not carried forward and are lost. When you sell the property, no losses are triggered.

There are positions we take to negate some of the negatives of vacation home treatment. When allocating mortgage interest and property taxes between personal and rental use, a court case allowed a denominator of 365 in allocating, and we follow this treatment.

For example, if you rent a property 90 days and use it personally for 30 days, most expenses are allocated 75% rental and 25% personal (90/120). For interest and taxes, the case allowed a much larger allocation towards personal (365 days less the 90 rental days in this example, or 275/365 personal use). This reduces the loss on Schedule E, which would go unused in any event, and moves more deductions to itemized mortgage interest and taxes on Schedule A.

What Constitutes a Day of Personal Use?

This concept is not as simple as it seems. If you let friends and family use your property at no rent or below market rent that constitutes a day of personal use. If you were to stay at the property for several days to do work such as painting or repairs, it is our opinion that those days are not personal days for this test.

IV. WHICH IS BETTER – RENTAL TREATMENT OR VACATION HOME TREATMENT?

Generally, from a purely financial standpoint, limiting your personal use to 14 days per year will produce a better overall financial and tax result. However, if you are purchasing a property to use as a vacation home with rental periods to help defray the cost of ownership, the financial benefits of limiting personal use are usually not that compelling to limit you to 14 days of personal use per year. In conclusion, if you wanted to use a property more than 30 days a year personally, we would attempt to get the best vacation home result from a tax standpoint.