

Deducting Mixed-Use Vacation Home Expenses: Uncertainty in the Taxpayer's Favor

By Vlad Frants*

Introduction

You have been consulted by a taxpayer, who owns a two-bedroom vacation home. The taxpayer rents it to tenants for 90 days during the year and receives \$9,000 of rental income. The taxpayer uses the vacation home personally for 30 days during the year. The taxpayer pays property taxes of \$3,200, mortgage interest of \$4,000, and maintenance expenses of \$2,000; depreciation is computed as \$3,000. Not surprisingly, the taxpayer wants to know which expenses are deductible—and how much.

Relevant Statutes

Section 212(2) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property held for the production of income, but section 262(a) provides that no deduction is permitted for personal, living, or family expenses. Taxpayer's mixed-use scenario has both income-producing and personal aspects. When property that the taxpayer uses as a residence is involved, section 280A provides deduction ordering rules for and limitations on the taxpayer's allowable deductions.

Under section 280A(e)(1), personal use of a dwelling unit on even a single day during the tax year requires an allocation of expenses based on days of personal use and days of rental of the property at its fair rental value. If the vacation home is rented for 15 or more days during the tax year and it is used by the taxpayer for personal purposes for the greater of (1) more than 14 days or (2) more than 10 percent of the number of days during the year for which the home is rented, the deductions attributable to the rental activity are limited. I.R.C. § 280A(d)(1).

Expenses allocated to rental days are deductible only to the extent of rental income. I.R.C. § 280A(c)(5). Because the taxpayer rented the vacation home for 90 days and personally used it for 30 days, there must be such an allocation of expenses. As discussed below, the Service and the courts disagree as to *how* the allocation of expenses must be made.

The Relevant Approaches

Taxpayer's expenses fall into two categories. Two items, the property taxes and mortgage interest, would be fully deductible even if the taxpayer used the property solely for personal purposes. I.R.C. §§ 163(h) (subject to the limits therein) & 164(a). Maintenance and depreciation expenses, on the other hand, are deductible only if there is a business or income-producing activity. Section 280A(e)(2) indicates that the limitations discussed below do not apply to the first category of expenses. But, as discussed below, the allocation of those expenses between personal and income-producing uses affects the limitations imposed on the second category.

The Service computes the expenses attributable to rental use as a percentage: the total days rented divided by the total

days used. In the example posed, all expenses would be allocated 75% to the rental days and 25% to the personal days. In computing the limitation, the Service offsets the rental income by deductions in the following order: (1) mortgage interest and property taxes; (2) maintenance expenses; and (3) depreciation. I.R.C. § 280A(e)(1); Prop. Treas. Reg. §§ 1.280A-3(c)(4) & 1.280A-3(d)(3).

The Tax Court and two appellate courts have rejected the Service's formula. *Bolton v. Commissioner*, 77 T.C. 8 (1981), *affirmed*, 694 F.2d 556 (9th Cir. 1982); *McKinney v. Commissioner*, 41 T.C.M. (CCH) 1272 (1981), *modified by* 42 T.C.M. (CCH) 467, *affirmed*, 732 F.2d 414 (10th Cir. 1983). *See also Ruggiero v. Commissioner*, 74 T.C.M. (CCH) 662 (1997). In *Bolton*, the Tax Court agreed with the taxpayer that interest and taxes accrue on a daily basis regardless of use. In upholding the Tax Court's position, the Ninth Circuit noted that "the number of days rented/total number of days used" fraction is not appropriate for allocating expenses such as interest and property taxes." 694 F.2d at 561. Although these courts employ a formula that computes the percentage limitation for interest and taxes by dividing the total days rented by the total days in the year, they limit other expenses using the Service's method (number of rental days/divided by number of days used).

Application to the Taxpayer

The table below reflects the facts set forth in the Introduction. The Service method would allocate 75% (90 days rented/120 days used) of all expenses to rental use. In contrast, the Tax Court would allocate only 25% of taxes and interest to rental use (90 days rented/365 days, ignoring rounding error); it would allocate 75% of other expenses (maintenance and depreciation) to rental use. In either case, allocable expenses in excess of rental income are carried forward to the next year.

* New York, NY.

In addition to the \$9,000 of deductions allowed using the Service method for allocating expenses under section 280A (or the \$5,550 using the Tax Court method), the taxpayer can also deduct interest and taxes allocable to the non-rental use. Using the Service method, the taxpayer would have itemized deductions totaling \$1,800; using the Tax Court method, the taxpayer would have itemized deductions totaling \$5,400. The total

deductions, combining both rental and personal use and ignoring any limitations under section 68, are \$10,800 using the Service method and \$10,950 using the Tax Court method. Because depreciation was limited using the Service method, the taxpayer's basis at the end of that year would be slightly higher than it would have been using the Tax Court method.

The Tax Court method gives better results in the example above. Will that

always be the case? The Tax Court method uses 365 as its denominator for allocating interest and taxes, while the Service method (assuming the property is not used every day) uses a smaller denominator. Both methods use the same numerator. As a result, the Tax Court method will invariably allocate a smaller amount of the interest and taxes to the rental use. Thus, the Tax Court method potentially allows a larger deduction for maintenance and depreciation. When coupled with the itemized deductions available for the remaining interest and taxes, the Tax Court method is likely to provide larger total deductions. But a taxpayer who is more concerned with reducing adjusted gross income, or who is subject to the AMT, may attain better results using the Service method. Because taxpayers cannot change method from year to year, it is important to consider the taxpayer's overall results before selecting a method. ■

ITEM	SERVICE METHOD	TAX COURT METHOD
Rental Income	\$ 9,000	\$ 9,000
Mortgage Interest	-3,000	-1,000
Property Tax	-2,400	-800
Net Income Before Maintenance / Depreciation	\$ 3,600	\$ 7,200
Maintenance Expenses	-1,500	-1,500
Depreciation Expense	-2,100	-2,250
Rental Income After Deductions	\$ 0	\$ 3,450

Tax Bites in the 111th Congress

By Gail L. Richmond*

Many tax statutes include "Revenue Act" in their titles. It's an accurate descriptor, but oh so dull. Fortunately for our readers, many legislators understand the importance of creative naming. This Tax Bites presents an assortment of bills introduced in the early months of the current Congress. Readers can use the THOMAS website to follow their progress over the next year (and to decipher those represented by acronyms).

H.R. 30: 401Kids Family Savings Act of 2009

H.R. 53: Bad Polluters Act of 2009

H.R. 87: Put Your Money Where Your Mouth Is Act of 2009

H.R. 386: CLASS Act of 2009

H.R. 424: Protecting Senior's Nest Egg Act of 2009

H.R. 433: REWARD Act of 2009

H.R. 550: Get America Moving Again Act of 2009

H.R. 705: National STEM Education Tax Incentive for Teachers Act of 2009

H.R. 779: Tax Free Tips Act of 2009

S. 100: Home School Opportunities Make Education Sound Act of 2009

S. 144: Modernize Our Bookkeeping In the Law for Employee's Cell Phone Act of 2009

S. 243: GIVE Act of 2009

S. 278: Incentive to Serve Tax Act

S. 304: Main Street Recovery Act

S. 493: ABLE Act of 2009

S. 744: Affordable Tutoring of Our Children Act

S. 857: SERVE Act of 2009

S. 864: Public Good IRA Rollover Act of 2009

* Nova Southeastern University Law Center, Davie, FL.