Season 1 – Episode 7 - Navigating Home Office, Vacation and Below Market Rentals: An Insight into Section 280A

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're diving deep into the nuances of section 280 A of the Internal Revenue Code, which lays out the rules for deductions related to the use of a home for business or rental purposes. This can apply to several different scenarios, including the use of a part of your home as a home office, renting out a portion of your home below market rentals to a family member, or renting out a vacation home. Now, let's begin with an example. Imagine you're a self-employed graphic designer who uses a room in your home exclusively and regularly as your principal place of business. According to section 280 A, you may be eligible to claim the home office deduction. It's essential, though the space is regularly and exclusively used for business. Your office can't double as a guest room or a spot for the kids to play.

And if your home office takes up, say, 15% of your home total area, you'd be able to deduct 15% of the applicable costs. The IRS offers two methods for calculating the home office deduction the regular method and the simplified method. The regular method requires you to calculate your actual home office expenses. This can be somewhat complex, as it requires you to track all costs like mortgage interest, property taxes, utilities, repairs and depreciation. As I mentioned earlier, you'll calculate these as a percentage of your home used for business. The simplified option, on the other hand, is easier but less precise. You simply multiply $5 per square foot, and you could use up to 300 sq ft. For a maximum deduction of one $500. This method doesn't require you to keep track of specific expenses, and it simplifies the calculation. However, it might not provide as large of a deduction if your actual expenses are high.

It's important to note that you can switch between the regular or simplified method each year. Now, what happens when you later sell your home that you've used for business, particularly where you've claimed depreciation? The code section 121 exclusion allows you to exclude up to $250,000 if you're single, or $500,000 if married, filing jointly of the gain from the sale of your primary residence. So as long as your gain is not over $500,000 and you're married, you won't pay any tax when you sell your home. Now, you have to make sure that you've lived in the home for at least two of the last five years. And there are other rules in there as well that beyond the scope of the podcast. Now, here's the catch. If you've taken depreciation deductions for a home office, those deductions are subject to recapture when you sell the house, even if the gain is completely excluded.

Under 121, this is called depreciation recapture, and it's taxed as ordinary income. This means you can't avoid paying taxes on the portion of your gain equal to the depreciation deductions you took. So for example, if you took $10,000 in depreciation deductions over the years you used your home for business, that 10,000 would be taxed at your ordinary income tax rate at the time of the sale, regardless of the Section 121 exclusion. If you take the simplified method, though, for that year, no depreciation is claimed, and you would not have to recapture any depreciation for that year when you later sell the home. This underlines a fundamental theme of tax planning. It's not about the deductions you can take now, but also about the potential future tax implications. Now, let's consider a different scenario. Suppose you own a vacation home that you rent out for most of the year but also use for your own vacations.

In this case, Section 288 has specific rules on what you can and cannot deduct. If you rent the property for 14 days or less during the year, you don't have to report the rental income, but you also can't deduct any rental expenses. This is sometimes referred to as the Master's rule or the Augusta rule. If you rent it out for

more than 14 days and use it personally for the greater 14 days or 10% of the days you rent it to others, it's considered a personal residence. You must report all rental income, but you can deduct rental expenses up to the level of rental income. However, personal expenses like mortgage interest and property taxes may be deductible on Schedule A. If you limit your personal use to less than these thresholds, the property can be considered a rental property and losses may be deductible subject to the passive activity loss rules.

Now, let's discuss below market rentals. For many people, the idea of renting a property to a family member at a below market rate seems like a great idea. It can provide a home for a loved one and keep property in the family. However, it's crucial to understand the potential tax implications involved. When you rent property to a family member, the IRS will categorize it as a personal use property rather than a rental property. If you charge below market rent, what does this mean for you, the landlord? Well, it means you must report all rental income received, and you can only deduct mortgage interest and property taxes as itemized deductions on Schedule A, just like you currently do. If you own your home. Let's dive into an example. Suppose you rent a house to your daughter for $600 per month, but the fair market value is 1200 per month.

Over the year, you collect $7,200 in rental income. During the same period, you have expenses totaling $10,000, including things like mortgage interest, property tax, maintenance, repairs and insurance. As this is a personal use property, the IRS won't allow you to deduct the expenses other than the mortgage interest and property taxes. And regarding the mortgage interest deduction, depending on the balance of your total mortgage debt between the below market rental and your home, the mortgage interest may be limited. After the Tax Cuts and Jobs Act, the rules for deducting personal mortgage interest have changed. For new mortgages taken out after December 15, 2017, you can only deduct interest on up to $750,000 of qualified residence loans. These include loans used to buy, build or improve a main home or a second home prior to the December 15, 2007th date. 2017 date, the amount was a million dollars of debt to buy, build or improve your home, plus $100,000 for home equity debt.

So if the debt on your main home is older than December 15, 2017, and the below market rental property debt is newer than December 2017 date, then an allocation will have to be made and the calculation in practice can be somewhat complex. So for a quick example, let's consider your main home was purchased after 1215 2017 and the debt on the property throughout the year was over $750,000. The interest paid on the debt for the below market rental would not be deductible. The easiest way to plan around this negative tax result is to charge market value to your family member. This will allow for the rental to be treated as a for profit rental activity and all the expenses, including depreciation, will be deductible. If not practical to charge full rent, then at least knowing the tax implications will better help you understand the true cost of your generosity.

And I also want to note that if you charge below market rent to a non-relative, you can deduct the expenses against the income, but the total expenses will be limited total rental income. This is similar to the vacation rental issues we discussed earlier. Now, finally, let's consider the scenario where you rent part of your primary residence, such as like a basement apartment at fair market value. In this case, the rental portion of your home is treated as a separate structure for tax purposes, meaning you'll deal with it differently on your taxes than you would the personal use portion of your home. This separation allows you to deduct direct expenses in full. These are costs that are solely for the rental part, like repairs directly in the apartment or marketing costs to advertise the rental. Indirect expenses, those that benefit the entire home, like utility bills or home insurance, are apportioned based on the size or usage of the rental part compared to the entire property.

You'd usually calculate this as a percentage of the square footage of the rental area to the total area of the home. Now let's consider what happens when you sell your primary residence that has a rental unit. As I mentioned earlier, the IRS allows you to exclude up to 250,000 if single, 500,000 if married of the gain from the sale of your primary residence under section 121. But what about the rented portion of your property? Here's where things get a bit complex. The section 121 exclusion only applies to the part of your property used for personal purposes. The portion of your property that you've been renting out is considered a separate piece of property for tax purposes and is not eligible for the section 121 exclusion. The gain from this portion of the sale is generally taxable, and any depreciation you've claimed on the rental part would be subject to depreciation recapture rules, which we discussed earlier.

Specifics of IRC section 280 A can be complex, with various exceptions and limitations. Always consult with a tax professional to ensure you are accurately applying the rules and making the most of your tax situation.

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