NEW TAX RULES BENEFIT FAMILY MEMBERS AND JOINT OWNERS OF RESIDENTIAL RENTAL PROPERTY

by Charles P. Edmonds and Rudolph Lindbeck

In 1981 Congress passed the Black Lung Benefits Revenue Act (the Act) which was intended to stimulate more creative financing especially among members of a family and joint owners. This article shows how the provisions of the Act provide significant investment incentives for residential investments.

The Act relaxes provisions of the Internal Revenue Code of 1954 (IRC) which limit tax deductions on vacation homes, rentals to family members, and rentals to joint owners. This exposition first examines the circumstances of a typical rental dwelling, then the provisions which have limited deductions, and finally the effects in two situations of the new tax rules. One situation involved a rental to a family member; the second one is the rental of a dwelling unit to an individual with an ownership interest in the property.

Typical Rental Circumstances

It is typical for a rental unit to produce a net loss and a tax benefit which are illustrated as follows:

Total rental income received		$4,000
Minus expenses:		
Fire insurance	$ 250	
Mortgage interest	1,000	
Real estate fee	297	
General repairs	175	
Real estate taxes	400	
Total expenses		2,122
Balance		$1,878
Minus:		
Depreciation		5,400
Net rental loss		($3,522)
Potential tax benefit (40%)		$1,409

The property in the preceding illustration must not be used for personal purposes. The IRC provides that if a dwelling unit is used as a personal residence by the owner for even one day during the tax year, expenses of the unit must be allocated between the rental use and the personal use. A day of personal use includes any day, or part of a day, that a dwelling is:

1) Used for personal purposes by an owner;
2) Used by a member of an owner's family [family includes brothers and sisters, ancestors, and lineal descendants (IRC Sec. 267(c)(4)]; or
3) Used by anyone at less than fair rental.

If family members and owners are included in the definition of personal use, the tax advantages of investing in such rental property as vacation homes, houses rented to relatives, or jointly owned property are severely limited.

In addition, special tax rules apply when rental property is used for personal reasons for more than 14 days or more than 10 percent of the number of days the unit is rented during the year, whichever is greater. In this case the house is considered a residence and expenses are deducted in the following order:

1) Interest, taxes, and casualty losses that are for the rental use.

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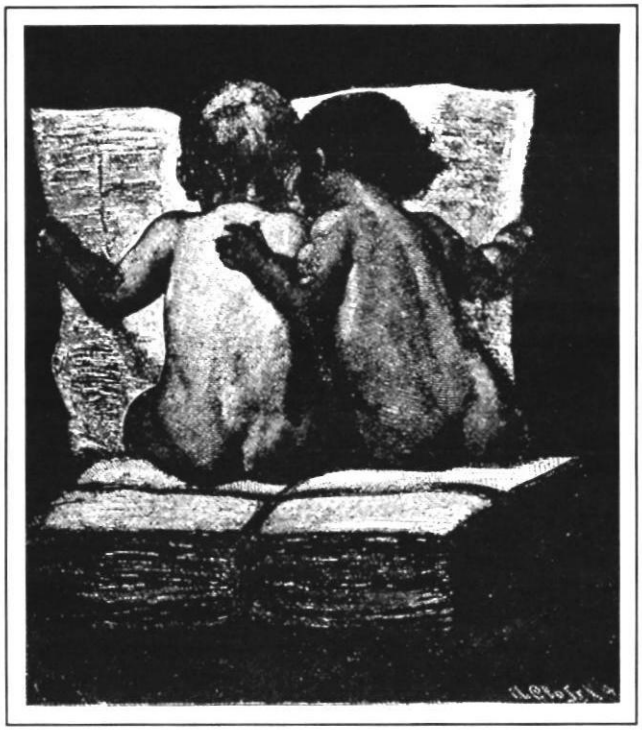

2) Operating expenses, except depreciation and other basis adjustments, but only to the extent rental income exceeds the deductions in 1). *No loss is deductible.*
3) Depreciation and other basis adjustments, but only to the extent rental income exceeds the deductions in 1) and 2). *No loss is deductible.*

The tax consequences of making personal use of rental property are shown in Examples 1 and 2 which follow.

New Tax Rules

The new tax rules allow investors in certain situations to deduct all ordinary and necessary expenses connected with dwelling units rented to either a family member or a joint owner.

Rental to Family Members

The new tax rules of the Act relax the limits imposed upon expenses which may be deducted on a dwelling unit rented to a family member. These rules provide that an owner of a dwelling unit is not using such unit for personal purposes if the unit is rented to any person at fair rental for use as that person's principal residence [Sec. 280A(d)(4)]. Thus, a dwelling unit rented to a member of the owner's family does not constitute personal use by the owner, provided that the dwelling unit is rented at a fair rental for use as the family member's principal residence. This new rule permits parents, for example, to gain the same tax advantages from rental to a son or daughter, as from rental to a third party.

The new tax rules do not apply if a dwelling unit is rented to the family member at less than a fair rental. The vacation home rules illustrated in the preceding section still apply. If the family member pays a fair rental, the new tax rules entitle the owner of the dwelling unit to deduct all ordinary and necessary expenses as shown at the beginning of this paper. Fair rental is determined by consideration of such factors as whether the rent paid is comparable to other rentals in the area and whether substantial gifts were made to the family member either when a lease is executed, or periodically during the year (Congressional Record, pages S15, 476-15, 477, 12-16-81).

Furthermore, the new rules are effective for taxable years beginning after December 31, 1975, but claims for refunds are subject to a three-year statute of limitations, so that amended returns for calendar year 1979 must have been filed by April 15, 1983 (Sec. 113(e), Public Law 97-119).

Assume that an investor purchases a house for $60,000 and finances $50,000 at 15 percent for 25 years. The land is valued at $10,000. Now assume that the house is rented at a fair market rate to a family member as a principal residence. According to old tax laws, renting to a family member is considered personal use by the investor. As a consequence, the tax rules for vacation homes would have applied.

Table 1 shows the investor's cash flows and internal rate of return based on old tax laws. These results should be compared with Table 2, which is based on the same assumptions and the new tax changes contained in the Black Lung Benefits Revenue Act. While this illustration is based on a rental house, the same rules now apply on a prorated basis to property in which a family member rents only a portion, say two rooms in the residence of the investor.

Rental to Joint Owners

A dwelling unit is not used for personal purposes under the new rules if it is rented at a fair rental to a co-owner under a shared equity agreement [Sec. 280A(d)(3)(B)]. If two or more persons acquire a qualified interest in a dwelling unit, one or more of such owners is entitled to occupy the property for use as a principal residence provided that fair rental is paid. Qualified interest means an undivided interest held in fee simple or for a term longer than fifty years. Rent must be paid in proportion to the shared equity. Prior to this change, joint owners could rent the property, but for tax purposes the rules for "vacation homes" applied. Realizing the restrictive nature of this situation, Congress sought to open the doors to more creative financing.

The new rules, for example, permit parents to help children obtain an interest in a home by sharing equity with them. Table 3 illustrates how such an arrangement has become more appealing. Assume the same house used in Tables 1 and 2 is jointly owned by a father and son. Each has a 50 percent interest, and each pays half the $602 monthly mortgage payment. Because of the provision in the Black Lung Act, the father's first year cash flow increases from −$1,545 to −$105.

TABLE 1

Cash Flows for a House Rented to a Family Member: Previous Tax Laws[1]

		Year 1	Year 2	Year 3	Year 4
Gross rental income		$4,800	$4,800	$4,800	$4,800
Minus:					
Interest		7,034	6,994	6,958	6,914
Taxes		600	600	600	600
Net rental income		($2,834)	($2,794)	($2,758)	($2,714)
Tax benefit (40%)[2]		$1,134	$1,118	$1,103	$1,086
Gross rental income plus tax benefit		5,934	5,918	5,903	5,886
Minus all cash expenses[3]		9,024	9,024	9,024	9,024
After-tax cash flows		($3,090)	($3,108)	($3,121)	($3,138)
Cash Flow From Sale of House					
Selling price[4]	$87,846				
Less: mortgage balance	48,995				
taxes	4,455				
Net sales proceeds	$34,396				
Tax on Sale of House					
Selling price	$87,846				
Minus adjusted base	60,000				
Gain on sale	$27,846				
Less 60% exemption	16,708				
Taxable gain	11,138				
Tax 40%	4,455				

IRR = 16.61%

1. The house is assumed to be sold in four years.
2. Assume investor is in 40 percent tax bracket.
3. Mortgage payments and operating expenses are assumed to be $7,224 and $1,800, respectively.
4. Assume the house appreciates in value an average of 10 percent each year.

Example 1: You own a summer home and used it for 10 days during the year. You rented the home at a fair rental for 110 days during the year. Your rental income is $5,400. Your total expenses are as follows:

Interest	$1,800
Taxes	1,200
Operating expenses	2,400
Depreciation	1,500

Because you used the summer home for less than 15 days, and 10 percent of 110 days in only 11 days, you did not use the home as a residence. However, you must divide the total expenses between the rental use and the personal use of the home. You figure that eleven-twelfths (110 days of rental use divided by 120 days of total use) of the total expenses are for the rental use of the property. You figure your rental income and expenses as follows:

Gross rental income		$5,400
Minus:		
1) Part of interest for rental use ($1,800 x 11/12)	$1,650	
2) Part of taxes for rental use ($1,200 x 11/12)[1]	1,100	
3) Part of operating expenses for rental use ($2,400 x 11/12)	2,200	
4) Part of depreciation for rental use ($1,500 x 11/12)	1,375	6,325
Net rental loss		($ 925)

Example 2: You own a cabin that you rented for two months, lived in for one month, and tried to rent the rest of the year. Your rental income for the two

TABLE 2

Cash Flows for a House Rented to a Family Member:
Current Tax Laws

		Year 1	2	3	4
Gross rental income		$4,800	$4,800	$4,800	$4,800
Minus:					
Interest		7,034	6,994	6,958	6,914
Taxes and other operating expenses		1,800	1,800	1,800	1,800
Depreciation		6,000	5,000	4,500	4,000
Net rental income		($10,034)	($8,994)	($8,458)	($7,914)
Tax benefit (40%)		$4,014	$3,598	$3,383	$3,166
Gross rental income plus tax benefit		8,814	8,398	8,183	7,966
Minus all cash expenses[1]		9,024	9,024	9,024	9,024
After-tax cash flows		($210)	($626)	($841)	($1,058)
Cash Flow From Sale of House					
Selling price	$87,846				
Less: mortgage balance	48,996				
taxes	9,056				
Net sales proceeds	$29,794				
Tax on Sale of House					
Selling price	$87,846				
Minus adjusted base	40,500				
Gain	$47,346				
Taxed as ordinary income[2]	6,167				
Taxed as capital gain	$41,179				
Tax	9,056				

IRR = 27.25%

1. Includes mortgage payment, taxes, and other operating expenses.
2. The accelerated cost recovery system is used for depreciation, which requires $6,167 in excess of straight line to be recaptured as ordinary income.

TABLE 3

Annual Cash Flow for the Father:
Assuming Old Laws and then the New Laws

	Old		New
Gross rental income	$2,400	Gross rental income	$2,400
Minus:		Minus:	
Interest (50%)	3,517	Interest (50%)	3,517
Taxes (50%)	300	Taxes and other operating expenses (50%)	900
		Depreciation (50%)	3,000
Net rental income	(1,417)	Net rental income	(5,017)
Tax benefit (40%)	567	Tax benefit (40%)	2,007
Gross rental income plus tax benefit	2,967	Gross rental income plus tax benefit	4,407
Minus 50% of all cash expenses[1]	4,512	Minus 50% of all cash expenses[1]	4,512
After-tax cash flow	$(1,545)	After-tax cash flow	$ (105)

1. Half the annual mortgage payment is $3,612, and half the operating expenses are $900.

months was $2,800. Your total expenses for the cabin were as follows:

Interest	$1,500
Taxes	900
Utilities	760
Maintenance	300
Depreciation	1,200

You must divide the expenses between the rental use and the personal use. Because you rented the cabin for two months, two-thirds (two months of rental use divided by three months of total use) of the total expenses are for the rental use of the cabin. You figure your rental income and expenses as follows:

1) Gross rental income		$2,800
2) Minus[2]		
a) Part of interest for rental use ($1,500 x 2/3)	$1,000	
b) Part of taxes for rental use ($900 x 2/3)	600	1,600
3) Gross rental income that is more than the interest and taxes for rental use		$1,200
4) Minus		
a) Part of utilities for rental use ($750 x 2/3)	$ 500	
b) Part of maintenance for rental use ($300 x 2/3)	200	700
5) Gross rental income that is more than the interest, taxes, and operating expenses for rental use		$ 500
6) Minus depreciation limited to the part for rental use ($1,200 x 2/3= $800) or line 5, whichever is less		500
7) **Net rental income**		$ 0

Conclusion

In an effort to open up another avenue for creative financing, Congress passed the Black Lung Benefits Revenue Act of 1981. The basic provision of the Act changed the tax consequences of renting property to family members and/or joint owners. An investor will no longer be considered as using a dwelling for personal purposes for renting, at a fair rent, to any person for use as such person's principal residence.

Because of the change, parents, other relatives, and joint owners are free to engage in rental and shared equity agreements without sacrificing tax benefits. The illustrations presented in this paper reveal that the impact of this new Act can result in a significant improvement in an investor's annual cash flows and rates of return. The Act will not solve all the problems currently facing the residential real estate market, but it will help. Individuals now have another potential way to finance the purchase of a residence.

NOTES

1. The additional interest ($150) and tax ($100) can be deducted if a person files an itemized return. Source: *Rental Property,* IRS publication 527, November 1981, 11.
2. The additional interest ($500) and tax ($300) can be deducted if a person files an itemized return. Source: *Rental Property,* IRS publication 527, November 1981, 11.