YOU PLAN TO BUY A HOUSE AND RENT IT TO THE KIDS. REALLY? CAREFUL PLANNING IS NECESSARY

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ABSTRACT

Parents often want to assist their children by helping them enjoy suitable housing. There are a number of mechanisms to accomplish this goal, some of which have good income tax and estate tax planning benefits; and others, with negative effects. Owning a house and renting it to family members (for other than fair rental value) can significantly limit ones intended tax benefits. But, helping family members purchase a house, or co-owning one, can, if properly structured, provide excellent tax benefits, year after year. This paper investigates some of the controlling statutes, addresses some planning opportunities, and provides a model that illustrates some of the cash flow effects.

INTRODUCTION

Parents who help their children enjoy upgraded housing, or not, have numerous choices, and their personal preferences, along with tax considerations, must be considered. The tax considerations can be significant. Renting the property to family members can be one of the worst options. If reported properly, the parent's will have rental income and they can claim deductions for rental expenses including mortgage interest and depreciation. The negative consequences are that the rent paid by the children provides no tax benefit to them because it is simply not deductible by the children. Furthermore, there are statutory limits on rental deductions for the parents (e.g., the passive loss limitations).

There are many more favorable possibilities to consider. One would be to provide a down payment as a gift or a loan. Interest would need to be charged pursuant to the applicable federal rates on a loan. The loan would also need to be secured by the residence in order for the children to deduct the interest as qualified mortgage interest expense. Another possibility would be to jointly finance the property and have the children pay all or most of the interest and taxes, as well as the other costs of maintaining the property.

In each case, properly structured, the parent does not have rental income and the children get the tax deductions for the interest and property taxes that they actually pay. Or, in some situations, the parents could make the payments and enjoy the deductions, assuming the requirements discussed later are met. The model provided later in this paper illustrates the annual cash flow effects of renting versus ownership, or co-ownership for a modest residence. The model allows the user to adjust the effective tax rates and the amount of the cost being financed.

STATUTORY CONSTRUCTION

Residence Interest

While personal interest is generally disallowed, residence interest is deductible for acquisition indebtedness up to $1 million and for home equity debt up to $100,000. The limit is an aggregate limit for the taxpayer's qualified residence and one other residence [Internal Revenue Code (IRC) § 163(h)(4)(A)(i)].

The principle residence is the one that qualifies as a "principal residence" under Internal Revenue Code §121. This provision provides for the exclusion not to exceed $250,000 with special rules for joint returns on the sale of a qualified residence. Essentially, a residence qualifies for the exclusion if it was the taxpayer's principal residence for two of the five years preceding its sale. Essentially, a residence qualifies for the exclusion if it was the taxpayer's principal residence for two of the five years preceding its sale.

Principal Residence

The statute does not address the determination of one's primary residence, but the Treasury Regulations do. One's principal residence, if there is more than one, is determined by the facts and circumstances. It will generally be the one where the taxpayer spends the most time [Treasury Regulation (Reg.) §1.121-1].

In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to (quote)—

- **(i)** The taxpayer's place of employment;
- **(ii)** The principal place of abode of the taxpayer's family members;
- **(iii)** The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- **(iv)** The taxpayer's mailing address for bills and correspondence;
- **(v)** The location of the taxpayer's banks; and
- **(vi)** The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Other Residence

The one other (or second) residence must qualify as the taxpayer's residence under IRC § 280A(d)(1), the section dealing with the business use of a home and/or rental of vacation homes. Under this provision, a residence is deemed to be used as a personal residence if it is used by the taxpayer for personal purposes exceeding the greater of 14 days, or 10 percent of the number of days the residence is used as a fair rental.

For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used (quote – IRC §280A(d)(2))—

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or . . . .

The rules applicable to repair and maintenance days are not discussed here [see IRC §280A(d)(2)(C)].

Under § 267(c)(4), the family of a taxpayer includes "only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." However, a taxpayer will not be treated as using a residence for personal purposes if it is rented to anyone at a fair rental value for use as that person's principal residence. This extends to a residence that is rented under a shared equity financing agreement, i.e., an agreement under which two or more persons own an undivided interest in a property that is used as the principal residence of one owner who pays a fair rental to the other party(ies) [IRC §280(A)(d)(3)(C)].

In short, if a fair rent is charged to a family member, the property will be treated as rented for tax purposes at arms' length and not be subject to the limitations mandated under IRC §280(A). The owner, or partial owner, has rental income and can deduct rental expenses.

The significance here is that the parent is deemed to have used the residence for any day that the child uses the property at less than a fair market rental rate.

REQUIREMENTS TO DEDUCT RESIDENCE INTEREST

Forbes.com published an interesting article in December 2014 that elaborates on the requirements for deductibility of residential mortgage interest. The author goes over the five considerations for determining deductibility. He also goes over some recent cases with favorable results, and others with unfavorable ones.

The requirements, most of which were covered earlier, are these (paraphrase):

1. Who paid the mortgage, because only the payer can deduct the interest?
2. Who is the borrower, because in order to deduct the interest, the payer must be obligated?
3. Who has legal title to the residence, because an owner of a residence secured by a property is deemed obligated?
4. Is the loan secured by the residence, a statutory requirement for deductibility as residence interest?
5. Do the limits on the amount of indebtedness apply?

The discussion of the issues relevant to this topic is very good [Tony Nitti, "Five Traps To Avoid When Deducting Mortgage Interest," ***Forbes***, December 30, 2014, http://www.forbes.com/sites/anthonynitti/2014/12/30/five-traps-to-avoid-when-deducting-mortgage-interest/].

QUI VAN PHAN CASE

Qui Van Phan's parents were divorced and his mother ended up with a residence located on a five-acre property. The mother was unable to care for the property so Van Phan agreed to pay the mortgage and maintain the property. The Internal Revenue Service [IRS] disallowed Van Phan's interest deduction of $35,880 for 2010, assessing income tax of $8,970 and accuracy related penalties of $1,794. Since Van Phan made the mortgage payments, no one else would have been able to claim the deduction.

Testimony was provided to the effect that there was an understanding that Van Phan was earning an equity interest by making the mortgage, tax, and maintenance payments. In 2011, Van Phan's sister and sister-in-law refinanced the mortgage and in 2013, Van Phan's name was added to the legal title to the property.

In a summary decision that sets no precedent, the Tax Court ruled that the 2013 recording, and the other facts surrounding the case, indicated that Van Phan did have an equity interest as claimed in 2010. Since he had an (equitable) interest and the loan was secured by an interest in the property, Van Phan was obligated to make the payments. Van Phan's deduction was sustained, resulting in no tax deficiency or penalties assessed [Qui Van Phan v. Comm., T.C. Summary Opinion 2015-1 (January 12, 2015)].

The importance of this case is that it illustrates that taxpayers need to be sure that all of the requirements for deductibility are met. This case could have resulted in a different outcome had the facts and circumstances been different.

A MODEL

This model, which can be adapted to almost any situation, illustrates the cash flow for a modestly valued home when the property is rented versus when it is co-purchased. Based on certain assumptions, including a marginal tax rate of 25 percent, the cash flow difference is approximately $2,400 annually. Perhaps this doesn't seem like much, but it is an annuity for the duration of the arrangement for the parties involved. This model does not take into consideration the potential appreciation of the property which could be an additional financial benefit for both the parents and the kids.

	Parents	Kids	Net to Family	
Rent				
Rental income	$18,000	$18,000		Are you going to report this? What if it is a "rental" and you don't (bad idea)?
Interest expense	$7,200			Payer must be obligated to benefit.
Property taxes	$1,800			Payer must be obligated to benefit.
Depreciation	$6,545			Reduces basis. May, or may not, be an issue.
Operating expenses	$1,800			Who is going to pay for repairs and maintenance? Be clear.
Net taxable	$655			
Tax at 25%	$164			
Principle reduction	-$1,000			
Net cash outflow	$6,036	$18,000	$11,964	
Buy				
Rental income	N/A	N/A		
Interest expense	N/A	$7,200		Payer must be obligated to benefit.
Property taxes	N/A	$1,800		Payer must be obligated to benefit.
Depreciation	N/A	N/A		
Operating expenses	N/A	$1,800		Who is going to pay for repairs and maintenance? Be clear.
Net taxable	N/A	-$9,000		
Tax at 25%	N/A	$2,250		
Principle reduction	N/A	-$1,000		This represents about a 20% difference in cash flows.
Net cash outflow	$0	$9,550	$9,550	

CONCLUSION

This paper and the model illustrate that a family rental can have significant cash flow effects. These are the first steps in a more detailed analysis. Families should consider multiple options and choose the best option to achieve the personal and financial goals of all involved.

REFERENCES

1. Internal Revenue Code of 1986.

2. U.S. Treasury Regulations.

3. Qui Van Phan v. Comm., T.C. Summary Opinion 2015-1 (January 12, 2015)

4. Tony Nitti, "Five Traps To Avoid When Deducting Mortgage Interest," ***Forbes***, December 30, 2014, http://www.forbes.com/sites/anthonynitti/2014/12/30/five-traps-to-avoid-when-deducting-mortgage-interest/