

Renting to a Related Party

Renting out a home or apartment that you own may result in a tax loss for you, even if the rental income is more than your operating costs. This is because you will be entitled to a depreciation deduction for your cost of the house or apartment (except for the portion allocated to the land). If your tenant is related to you, however, special rules and limitations may apply. (For these purposes "related" means spouse, child or grandchild, parent or grandparent, and siblings.) Here's the tax picture:

If you rent a home to a relative who (1) uses it as his or her principal residence (that is, not just as a second or vacation home) for the year, and (2) it's rented **at a fair rental value** (not at a discount), then no limitations apply. You can deduct all the normal rental expenses, even if they result in a rental loss for the year. (Losses on rentals are considered "passive", which may be limited to passive income for the tax year.)

The problem arises if you set the rent **below the fair rental value**. If rented below fair rental value, the rental is treated as being used personally. You would have to allocate the expenses between the personal and rental use portions of the year. Even more seriously, since all the rental days (at a bargain rate to a relative) are treated as personal days, the qualifying "rental use" portion is zero. Thus, you would have to report all of the rent you receive as income, but none of your expenses for the home would be deductible. (You would still be able to deduct the mortgage interest, assuming it otherwise qualifies as deductible, and property taxes. These items are deductible even for nonrental homes, but you would have to itemize to claim them.)

Given the above, it is important to set the rent at a fair rental value of the home.

Side gifts, meant to cause the rental to appear to be at fair rental value, while reducing the actual cost of the rental to the tenant, can cause the rental to be treated as being rented below fair rental value.

The value of any discount below fair market value should be considered a gift for gift tax reporting purposes.

If you would like to discuss any of this information in more detail please contact the office to schedule a consultation.