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Dear Client:

You recently asked about the tax consequences of renting a home you own to a relative.

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 (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. (If you have a loss, however, it is a "passive" loss, which may be subject to a different set of limitations. Please let me know if you'd like additional information on this topic.)

The problem arises if you set the rent below the fair rental value. Since this then becomes a rental property which you are treated as using personally, you would have to allocate the expenses between the personal and rental portions of the year. Even more seriously, however, since all of the rental days (at a bargain rate to a relative) are treated as personal days, the rental portion is zero. Thus, you would have to report all of the rent you receive in income, but none of your expenses for the home would be deductible. (Actually, 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.)

Given the above, it is important to set the rent at a fair rate. Factors to look at include comparable rentals in the area and whether "side" gifts were made by you to your relative which could be reasonably interpreted to be the bargain element.

If you would like to discuss any of these matters in more detail, please call.

Very truly yours,

Shawn Filder