

## Comprehensive Research Example

### Step 1: Establish the Facts and Determine the Issues

Sam, a surgeon, and his wife, Sara, own and rent out a vacation home. During the year, they use the home 20 days and rent it out for 40 days. Rental income for the year is \$4,000. Total expenses are as follows:

Interest and taxes	\$4,200
Utilities and maintenance	1,500
Depreciation	6,000

Sam has asked for assistance in determining the tax treatment of these expenditures.

### Step 2: Locate the Relevant Authorities

Using any of the tax services leads to Sec. 280A, “Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Homes, Etc.” A review of the editorial discussion and annotations indicates that Prop. Reg. Sec. 1.280A-3 and *Bolton v.*

*Commissioner*, 694 F.2d 556, 51 A.F.T.R.2d 83-305, 83-20 USTC ¶9699 (9th Cir., 1982), affirming 77 T.C. 104 (1981), may also be applicable.

### Step 3: Assess the Importance of the Authorities

Completion of this step requires review of each authority identified to determine its applicability. Always examine the relevant Code section first. If questions remain unanswered, you must look to the administrative and judicial interpretations to see if they provide definitive answers or at least some direction.

#### The Code

Exhibit 16–7 provides the relevant portions of Sec. 280A. The general rule of Sec. 280A(a) limits a taxpayer’s business deductions for expenses incurred for a dwelling unit if that unit was used as a personal residence during the taxable year. Under Sec. 280A(d)(1), the general rule of Sec. 280A(a) applies if the taxpayer’s personal use of the dwelling unit exceeds the greater of 14 days or 10 percent of the number of days the unit is rented. Because Sam and Sara’s personal use of the vacation home exceeds both 14 days and 10 percent of the rental days, the general limitation applies.

Sec. 280A(b) provides that nonbusiness expenditures otherwise deductible (e.g., taxes, interest, and casualty losses) are not subject to the general limitation in Sec.

280A(a). Sec. 280A(c)(3) provides another exception to the general limitation by allowing a deduction for “any item attributable to rental of the unit” (e.g., utilities, maintenance, and depreciation). The latter so-called maintenance expenditures, however, must first be allocated to the rental use under the rules of Sec. 280A(e)(1) and then are limited under the rules of Sec. 280A(c)(5).

Sec. 280A(e)(1) requires that the maintenance expenditures attributable to the rental use be allocated using the following formula:

$$\frac{\text{Number of days in the tax year the unit is rented}}{\text{Total number of days in the tax year the unit is used}}$$

All maintenance expenditures are multiplied by this ratio to arrive at a tentative deduction figure. Applying the formula to the facts for Sam and Sara results in the following calculation:

$$\frac{40 \text{ (days rented)}}{60 \text{ (days used)}} \times 66.67\% \times \$7,500 = \$5,000$$

In other words, of the total maintenance expenditures of \$7,500, the maximum amount allocable to the rental activity that may be deducted is \$5,000.

Sec. 280A(c)(5) may further limit deductions for maintenance expenditures. It provides that all expenses (interest, taxes, casualty losses, and maintenance expenditures) allocable to the rental activity cannot exceed the gross rental income. Further, it requires that deductions allowed (e.g., interest, taxes, and casualty losses), whether the unit was used as a rental or not, be allocated to the rental activity and to the amount otherwise allowable as itemized deductions. Any maintenance expenditures are then allowable to the extent that gross rental income exceeds the interest, taxes, and casualty losses allocable to the rental use. Although Sec. 280A(e) does provide the rules for allocating the maintenance expenditures, it provides no guidance for allocating the interest, taxes, and casualty losses. As the editorial commentary in the tax service noted, this has been an area of dispute, with the proposed regulations suggesting one method and the court in *Bolton* suggesting another allocation method.

## Regulations

Prop. Reg. Sec. 1.280A-3(c)(1) requires that interest and taxes be allocated in the same fashion as maintenance expenditures under Sec. 280A(e)(1). For Sam and Sara, a tentative conclusion is that the allocation used should be 40:60 (as suggested in the proposed regulation), which would yield the following calculations:

	Total	Rental Use	Itemized Deduction	Not Deductible
Gross rental income	\$ 4,000	\$ 4,000	—	—
Interest & taxes	(4,200)	<u>(2,800)</u>	\$1,400	
Excess		\$ 1,200		
Maintenance	(7,500)	<u>(1,200)</u>		\$6,300
Total		<u>\$ -0-</u>	<u>\$1,400</u>	<u>\$6,300</u>

## Court Decision

In *Bolton*, the U.S. Court of Appeals for the Ninth Circuit affirmed a decision of the U.S. Tax Court which held that the interpretation provided in the proposed regulation was inconsistent with the statute, its history, and the legislative purpose behind Sec. 280A. The courts held that interest and taxes, unlike maintenance expenditures, are expenses that continue or accrue on a daily basis throughout the year. Accordingly, they should be allocated according to a ratio of days rented to total days in the year.

For Sam and Sara, a tentative conclusion using an allocation of 40:60 for the maintenance expenditures and 40:365 for interest and taxes, as suggested in *Bolton*, would be as follows:

	Total	Rental Use	Itemized Deduction	Not Deductible
Gross rental income	\$ 4,000	\$ 4,000	—	—
Interest & taxes	(4,200)	<u>(460)</u>	\$3,740	
Excess		\$ 3,540		
Maintenance	(7,500)	<u>(3,540)</u>		\$3,960
Total		<u>\$ -0-</u>	<u>\$3,740</u>	<u>\$3,960</u>

It should be noted that the proposed regulations were initially issued on August 7, 1980, and amended on July 21, 1983. The ninth circuit's decision in *Bolton* was rendered on December 2, 1982, which was before the last revision to the proposed regulations. The citator provides the information that the IRS has not issued an acquiescence or nonacquiescence to the unfavorable *Bolton* decision, that the ninth circuit's decision has been cited in numerous Tax Court regular and memorandum decisions, and that its decision has been followed by the tenth circuit in *Edith McKinney v. Comm.*, 732 F.2d 416, 52 A.F.T.R.2d 83-6281, 83-2 USTC ¶9655 (10th Cir., 1983).

Sec. 280A Disallowance of **Certain Expenses** in Connection with Business Use of Home, Rental of Vacation Homes, etc.

- (a) **General Rule.** Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable years as a residence.
- (b) **Exception for interest, taxes, casualty losses, etc.** Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).
- (c) **Exceptions for certain business or rental use; limitation on deductions for such use.**
  - ....
  - (3) **Rental use.** Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).
    - ....
  - (5) **Limitation on deductions.** In the case of a use described in paragraph (1), (2), or (4), and in the case of a use described in paragraph (3) where the dwelling unit is used by the taxpayer during the taxable year as a residence, the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of—
    - (A) the gross income derived from such use for the taxable year, over
    - (B) the sum of—
      - (i) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used, and
      - (ii) the deductions allocable to the trade or business (or rental activity) in which such use occurs (but which are not allocable to such use) for such taxable year. . . .
- (d) **Expenses attributable to rental.**
  - (1) **In general.** In any case where a taxpayer who is an individual or an S corporation uses a dwelling unit for personal purposes on any day during the taxable year (whether or not he is treated under this section as using such unit as a residence), the amount deductible under this chapter with respect to expenses attributable to the rental of the unit (or portion thereof) for the taxable year shall not exceed an amount which bears the same relationship to such expenses as the number of days during each year that the unit (or portion thereof) is rented at a fair rental bears to the total number of days during such year that the unit (or portion thereof) is used.
  - (2) **Exception for deductions otherwise allowable.** This subsection shall not apply with respect to deductions which would be allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was rented.