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Secrets to Pocketing Cash by Renting a Bedroom in Your Home

Say you own a three-bedroom home and rent one bedroom to third parties at fair market value.

Depending on the length of the rentals and the people to whom you rent, the tax code treats your bedroom rental as one of the following:

1. A tax-free activity.
2. A bedroom rental that you report on Schedule C of your Form 1040.
3. A bedroom rental that you report on Schedule E of your Form 1040.
4. A bedroom rental that's deemed by the vacation home rules under tax code Section 280A as a personal activity limiting your deductions to your rental income (no tax shelter here).
5. A bedroom rental subject to the Section 280A vacation home rules, under which it qualifies as a rental property.

The sharing economy, including firms such as Airbnb, has made bedroom rentals more common than just a few years ago. It's likely you know someone who rents a bedroom or two.

This article gives you, in plain English, the rules of the road on bedroom rentals. You will learn what to do, what not to do, and how to get the best possible after-tax cash result.

Big Picture

When you rent a bedroom or two or 20, you first examine Section 280A of the tax code to determine whether your bedroom rental is:

- Tax-free because your rentals were for fewer than 15 days during the tax year.¹
- Subject to Section 280A.
- Exempt from Section 280A.

When exempt from Section 280A, your bedroom rental faces four tax code sections:

1. Section 183, which requires a profit motive for you to claim any rental business tax deductions. Failing Section 183 requires the IRS to tax your bedroom income and give you no bedroom deductions other than mortgage interest and property taxes.
2. Section 469, which requires that you (or you and your spouse) materially participate in the property to claim any tax losses on the bedroom rental activity.
3. Section 1402, which requires you to report the activity on Schedule C and pay self-employment taxes on the net income when you provide services as part of the bedroom rentals.
4. Section 199A, which includes a tax deduction that you could claim if the bedroom rental is a business that qualifies.

Start in Section 280A

The first test is to see whether your bedroom rentals are Section 280A rentals. We used Proposed Regulation 1.280A-1(c)(2) and the IRS publication on rentals to create the following dos and don'ts table that you can use to see whether your bedroom rentals are Section 280A rentals:²

Do This	Don't Do This
Make the bedrooms regularly available for occupancy by paying customers.	Do not use the bedrooms personally.
Use the bedrooms exclusively for rental. ³	Don't allow friends or relatives to use the bedrooms rent-free, as this creates personal use.
Rent either to (1) tourists or (2) longtime boarders such as students.	Don't allow your brother or sister, spouse, ancestor, or lineal descendant to rent the bedrooms at any price, as their use, paid for or not, creates personal use by you. ⁴

If your bedroom rental does not comply with the rules above you have a Section 280 vacation home. We will cover the Section 280 vacation home rules next month.

If your bedroom complies with the rules above, your bedroom rental is not a Section 280A rental. Instead, your bedroom rental now faces Sections 183, 469, 1402, and 199A as we examine below.

One Big Test: The For-Profit Test

In an audit, the IRS is likely to assert that you are not in the bedroom-rental business to make a profit. Should the IRS win this not-for-profit argument, your rentals become a hobby, and that's a tax benefit disaster.

Why? Because the Tax Cuts and Jobs Act (TCJA) does not allow tax deductions for miscellaneous itemized deductions for tax years 2018 through 2025.⁵ And with no tax-code-qualified profit motive, you have what is commonly known as a hobby.

Your tax deductions for your bedroom rental hobby expenses, other than mortgage interest and property taxes, are miscellaneous itemized deductions that are not deductible in tax years 2018 through 2025.

Example. You have \$6,000 of rental income, \$2,000 of allocable mortgage interest and property taxes, and \$8,000 of other expenses, including depreciation. You pay taxes on \$4,000 of rental income (\$6,000 - \$2,000). You get no deductions for the \$8,000.

(Note. You are deducting the \$2,000 on Schedule A, and in this example, we assume you are benefiting from the \$2,000.)

Here are five tips to help you pass the for-profit test:

1. Assert that the bedrooms are going to appreciate in value along with the rest of the house, so the rental income is only part of the profit picture.
2. Create a plan for profits showing that rents will increase, expenses will decrease, and the property will appreciate.
3. Keep good records on the rental income and expenses.
4. Keep good records on advertising and other ways in which you find the renters.
5. Make sure you have some documents that show you are charging a fair or more-than-fair rent.

You need to beat the hobby loss rule or suffer under the TCJA, which is going to destroy your bedroom rental deductions other than mortgage interest and property taxes.

By following the five tips above, you have a good chance of avoiding the hobby loss rules.

So far, so good. Your next stop on your bedroom rental road is the passive loss rule.

Passive Loss Rules

Your bedroom rental got this far because it escaped the Section 280A vacation home limits and then passed the for-profit test. You must now consider the Section 469 passive loss rules.

Under these rules, your bedroom rental will produce

- a passive or business loss, if the bedroom shows a loss; or
- passive or business income, if the bedroom rental shows a profit.

Three Types of Bedrooms

Under the passive loss rules, your bedroom rental will fall into one of three categories:

1. A non-real-estate rental that's exempt from the real estate professional rules but subject to the material participation rules.
2. A business rental that's subject to the material participation rules and reported on Schedule C, subject to self-employment taxes.
3. A real estate rental subject to the passive loss rules that apply to the tax-code-defined real estate professional.

What Is It?

The first step to classifying your bedroom rental is to find the type of rental activity you have. Under the passive loss rules, you have a non-real-estate rental when your average period of rental

- is seven days or less,⁶ or
- is 30 days or less and you provide significant services.⁷

“Significant services” means services by individuals that cost at least 10 percent or more of the rent collected; such services do not include cleaning public entrances, exits, stairways, and lobbies, or collecting and removing trash.⁸

If your bedroom rental meets one of the two tests above, it is not a traditional rental real estate property, but a rental that you report on either Schedule C or E, as explained below. But first let's see if your bedroom rental can shelter your other income by allowing you to deduct your losses.

Deducting Losses

When you avoid the traditional rental activity rules, you simply need to “materially participate” in the bedroom rentals to deduct your losses immediately, on either Schedule C or E.

IRS regulations give you seven paths to material participation. The following two paths are the most likely to give you material participation for your bedroom rentals:

- **Path 1.** You (or you and your spouse combined) do substantially all the participation in the activity, when you consider participation by all individuals who participated.⁹
- **Path 2.** You (or you and your spouse combined) participate both (a) more than 100 hours and (b) more hours than the participation of any other individual.¹⁰

If you failed to materially participate according to Path 1 or 2, then consider the remaining five material participation tests described in *Make Your Rental Property Losses Tax Deductible*.

Two Steps for Bedrooms as Rental Real Estate

Step 1. If your bedroom rentals don’t qualify for the seven- or 30-day exceptions, the rentals are traditional real estate rentals, and your first step to achieve immediate deductions is to qualify as a real estate professional. For how this works, see *Make Your Rental Property Losses Tax Deductible*.

Step 2. If you qualify as a real estate professional, your next step is to materially participate. You can qualify as materially participating by following one of the two paths explained earlier.

Losses Suspended

If you don’t qualify to deduct your losses immediately, your rental losses go into the passive loss bucket, where you can realize the losses in the current or future years, depending on what’s inside the bucket and what types of activities you conduct.

Schedule C or E

IRS Reg. Section 1.1402(a)-4(c)(2) states that when you provide services as described in this regulation, you report your rental on Schedule C, where profits trigger the self-employment tax.¹¹

These are not the Section 469 “significant services” detailed above, but services other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.¹²

The supplying of maid service, for example, constitutes such service, whereas the furnishing of heat and light; the cleaning of public entrances, exits, stairways, and lobbies; the collection of trash; and so forth are not considered services rendered to the occupant.¹³

Working Example

Let's say you own and live in a three-bedroom home in the mountains. Primarily during winter and summer months, you rent two bedrooms for 305 days to 31 different people. The average rental is 9.8 days.

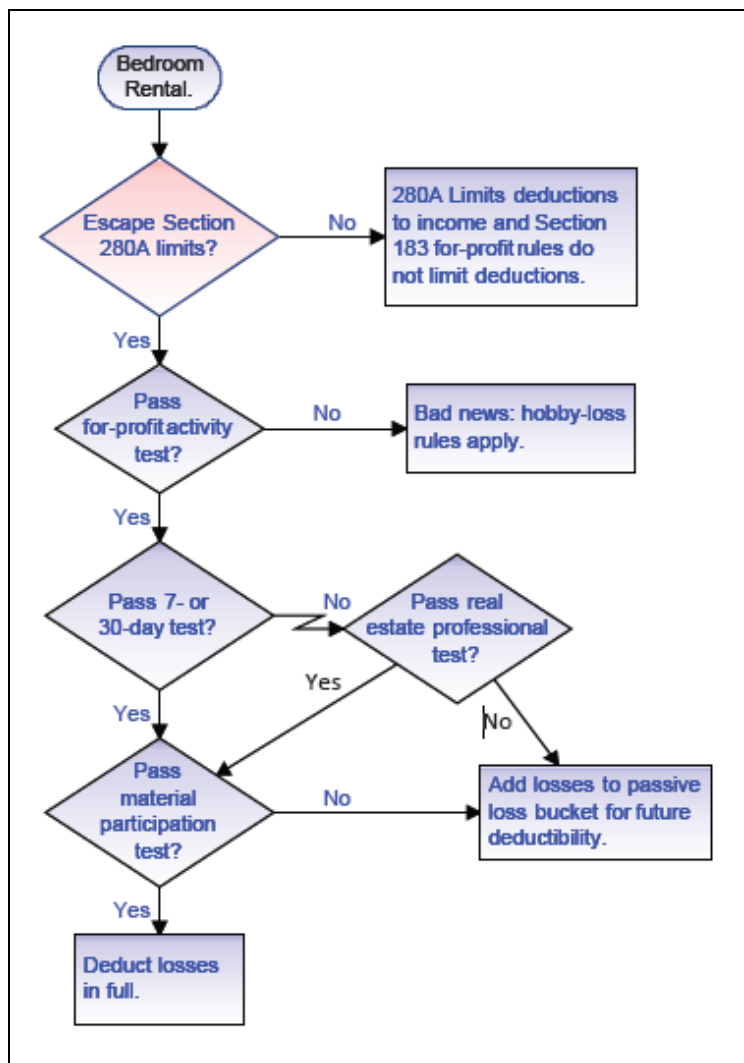
You and/or your spouse prepare the room for occupancy before and after the stays along with providing maid services every seven days (for stays longer than seven days). You also maintain and allow use of all the common areas of the home and prepare breakfast for the guests every morning. In addition, each of the 31 visitors gets your personal guided tour of the area, which takes about five hours, followed by dinner with you and/or your spouse.

Here's how the rules apply to this example:

1. You escape the Section 280A vacation home rules by renting to tourists and having no personal use of the bedrooms.
2. You can prove your profit motive and thus avoid the hobby loss rules.
3. You likely fail the significant services test because you and your spouse did the work and did not pay 10 percent or more of the gross income to individuals for qualified services.
4. You certainly provide more services than for mere occupancy, so you report the rentals on Schedule C.
5. Although they're on Schedule C, your bedrooms are rentals of real estate according to the passive loss rules. As rentals of real estate, you can deduct losses under the rules that apply to rental real estate.
6. This bedroom rental activity is likely a qualified business for Section 199A deductions.

Know this. You don't deduct the areas of the home that you use personally. That includes those areas you share with the bedroom renters. Your bedroom rentals are really a bed-and-breakfast business that faces all the rules explained above, including no deduction for the dual-use areas.

Quick Summary Flowchart



Takeaways

Wow, you have much to consider when you rent bedrooms:

1. You escape the Section 280A rules when you rent to tourists or students and have no personal use.
2. You need a profit motive to avoid the draconian hobby loss rules that steal your deductions.
3. Your bedroom rental is exempt from the traditional rental-real-estate passive loss rules when you rent for an average of seven days or less, or 30 days or less and you meet the significant services test.
4. You report bedroom rentals from number 3 above, on either Schedule C (as subject to self-employment taxes) or Schedule E (where net income is not subject to self-employment taxes).
5. When reporting under number 4 above, you must materially participate to deduct losses.

6. Your losses from failed material participation are suspended (not deductible this year) and may be used in future years to offset passive income.

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1 IRC Section 280A(g).

2 Prop. Reg. 1.280A-1(c)(2); IRS Publication 527, Residential Rental Property (2018), Dated Jan. 16, 2019, p. 17.

3 *Fine v U.S.*, 647 F.2d 763; *Byers v Commr.*, 82 T.C. 919; *Buchholz v Commr.*, T.C. Memo 1983-378.

4 IRC Section 280A(d)(2); Prop. Reg. 1.280A-1(e).

5 IRC Section 67(g) 2018.

6 Reg. Section 1.469-1T(e)(3)(ii)(A).

7 *Ibid*; Reg. Section 1.48-1(h)(2)(ii); also, the Senate Finance Committee report on P.L. 99-514 states: "A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or other similar transient lodging, for example, where substantial services are provided, is not a rental activity."

8 Reg. Section 1.469-1T(e)(3)(viii), Example (4).

9 Reg. Section 1.469-5T(a)(2).

10 Reg. Section 1.469-5T(a)(3).

11 Reg. Section 1.1402(a)-4(c)(2).

12 *Ibid*.

13 *Ibid*.
