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*Tax Treatment of Short-Term Residential Rentals Reform  
Proposal*

Louis Alan Talley and Pamela J. Jackson, Government and Finance Division

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**Abstract.** Generally, taxable income has included rental income from real property. However, an exclusion for de minimis rental income (from the rental of a taxpayer's residence for a period of less than 15 days per year) was enacted by the Tax Reform Act of 1976, (P.L. 94-455). Since that time, a number of tax reform proposals have called for inclusion of de minimis rental income as taxable income. The most recent proposal was contained in a report prepared by the Joint Committee on Taxation at the behest of Senators Grassley and Baucus. The proposal would cap the currently unlimited exclusion at \$2,000 and rental income greater than \$2,000 would be included as taxable income. Deductions for operating costs associated with the rental period (and depreciation) would be allowable but would be reduced in proportion to the ratio of excludable income to total rental income from the property. The effective date would be for taxable years beginning after the date of enactment.

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## Tax Treatment of Short Term Residential Rentals: Reform Proposal

Pamela J. Jackson  
Analyst in Public Sector Economics  
Government and Finance Division

### Summary

Generally, taxable income has included rental income from real property. However, an exclusion for *de minimis*<sup>1</sup> rental income (from the rental of a taxpayer's residence for a period of less than 15 days per year) was enacted by the *Tax Reform Act of 1976*, (P.L. 94-455). Since that time, a number of tax reform proposals have called for inclusion of *de minimis* rental income as taxable income. The most recent proposal was contained in a report prepared by the Joint Committee on Taxation at the behest of Senators Grassley and Baucus. The proposal would cap the currently unlimited exclusion at \$2,000 and rental income greater than \$2,000 would be included as taxable income. Deductions for operating costs associated with the rental period (and depreciation) would be allowable but would be reduced in proportion to the ratio of excludable income to total rental income from the property. The effective date would be for taxable years beginning after the date of enactment.

The proposed changes would provide more equitable tax treatment of income than current law, but at the cost of increased record-keeping for taxpayers and enforcement problems for the Internal Revenue Service. It appears that no changes would be made to present-law treatment of expenses allowable to taxpayers (e.g., mortgage interest, property taxes, and casualty losses). The Joint Committee on Taxation has estimated that the proposal would increase revenues by approximately \$10 million each fiscal year.

This report will be updated in the event of legislative changes.

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<sup>1</sup> In this report, *de minimis* refers to a small number of rental days and is not necessarily meant to imply small dollar amounts.

## Current Tax Law

Generally, taxable income has included rental income from real property. However, present law provides an exclusion for *de minimis* rental income. This exclusion applies to rental income collected for rental periods of less than 15 days per year. The exclusion may apply to rental income from either a primary home or a second home. The law also precludes a taxpayer from taking deductions for any operating expenses attributable to that income. Such operating expenses would include items such as gas, electricity, telephone/cable/internet services, or maintenance expenditures, and also depreciation. Current law allows taxpayers to claim a deduction for qualified home mortgage interest expenses and property taxes, which can include rental income property if the property is either the main home or the second home of the taxpayer. The tax law does not distinguish between personal and business use for the purpose of the interest and tax deductions for the short term rental period.

## Legislative History and Rationale

The exclusion of *de minimis* rental income was enacted by the *Tax Reform Act of 1976*, which had six stated major goals as reasons for passage. One those goals was to improve the equity of the tax system at all income levels without impairing economic efficiency and growth. Another of the stated goals was to simplify the tax law by modifying individual income tax deductions and credits. Before the passage of this act, the marketing of vacation homes frequently emphasized the tax benefits of renting the property for part of the tax year. Congress found it difficult to distinguish rental activities engaged in to make an economic profit from other rental activity. Accordingly, under the 1976 Act, Congress set up rules that limited deductions for rentals when the taxpayer also used the unit for personal use.<sup>2</sup>

Both the House and Senate bills for the 1976 Act provided a *de minimis* exclusion. While not specifically stated in their reports, it appears likely that Congress saw the exclusion as a simplification measure. The Senate bill would have provided an exclusion for short term rentals of less than one month over the course of a year. The conference agreement followed the House bill, which provided the exclusion for rentals of less than 15 days over the course of a year.

In 1992, the House passed H.R. 2735, which would have repealed the 15 days *de minimis* rule. That same year, another bill, H.R. 11, also would have repealed the broader exclusion but provided one exception. That exception stated that when “accommodations to visitors to an event for which commercial accommodations can provide no more than one-half of the needed accommodations, then the current-law exclusion (and denial of deductions) applies to the extent that the rental rate charged is not greater than the reasonable commercial rate.”<sup>3</sup> H.R. 11 was vetoed by former President George H. W. Bush and, thus, the provision did not become law.

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<sup>2</sup> Different rules apply depending on if the home is rented for more than 14 days a year and is used by the owner more or less than 14 days or 10% of the rental days (whichever is greater).

<sup>3</sup> U.S. Congress, Joint Committee on Taxation, *Comparison of Revenue-Related Provisions of H.R. 11 (Revenue Act of 1992) as Passed by the House and Senate*, JCS-16-92, 102<sup>nd</sup> Cong., 2d sess., (Washington: GPO, 1992), p. 36.

Other efforts to repeal the *de minimis* exclusion have been made. Repeal efforts were included in the House version of the *Balanced Budget Act of 1995* and the House version of the *Taxpayer Relief Act of 1997*. In both of these cases, the provisions for repeal were dropped while the bill was in Conference. The proposal again surfaced in 1997 and was introduced as a revenue offset to H.R. 2621 known as the *Reciprocal Trade Agreement Authorities Act of 1997*. This bill, reported by the House Ways and Means Committee, failed passage on a vote in the full House. The most recent proposal for change prior to the 109<sup>th</sup> Congress was made by President Clinton, who called for repeal of the *de minimis* exclusion as part of the FY2000 budget request made to Congress. Under President Clinton's proposal, the prohibition denying deductions associated with the costs incurred for the rental would also have been repealed.<sup>4</sup>

## Proposal for Change

On January 27, 2005, the Joint Committee on Taxation unveiled a new report entitled *Options to Improve Tax Compliance and Reform Tax Expenditures*,<sup>5</sup> which included a proposal to limit the exclusion for rental of a residence rented for fewer than 15 days. The proposal provided that the first \$2,000 of rental income would be excluded from the taxpayer's income. For those taxpayers whose rental income exceeds the \$2,000 amount, the proposal would allow for deductions attributable to the rental property (such as depreciation). However, these deductions would be reduced in proportion to the ratio of excludable rental income to total rental income. The Joint Committee on Taxation provided the following example of how this would work:

Taxpayer A rents his residence for fewer than 15 days during the taxable year. The taxpayer receives \$5,000 in rent and has \$2,000 of otherwise applicable deductions arising from such rental use. Under present law, none of the \$2,000 is deductible and none of the \$5,000 of rental income is included in gross income. Under the proposal, the allowable amount of the deduction is reduced by the ratio of excludable gross rental income to total gross rental income (i.e., \$2,000/\$5,000). This reduces the otherwise applicable deductions arising from such rental use by 40 percent from \$2,000 to \$1,200. After reducing the gross rental income of \$5,000 by the amount of the allowable deductions the taxpayer's net rental income is \$3,800. Of this amount, \$2,000 is excludable so the taxpayer has \$1,800 of taxable income from the rental of the residence.<sup>6</sup>

Current law prohibits deductions associated with the costs incurred with the *de minimis* rental income. Under the proposal made by the Joint Committee on Taxation this prohibition would be repealed. As such, taxpayers would be permitted to offset rental income by any expenses such as fees charged by rental agents, electricity, gas, house cleaner services, etc. when the rental income exceeds \$2,000. The proposal does not indicate whether the \$2,000 amount is to be adjusted for inflation in future tax years.

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<sup>4</sup> Taxpayers would have been permitted to offset rental income by an expenses such as fees charged by rental agents as fees, electricity, gas, house cleaner service, etc.

<sup>5</sup> U.S. Congress, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, committee print, JCS-02-05, 109<sup>th</sup> Cong., 1<sup>st</sup> sess. (Washington: GPO, 2005), pp. 57-58.

<sup>6</sup> Ibid.

While noting that the \$2,000 dollar limitation, or any amount, is arbitrary, the Joint Committee on Taxation explained that the current unlimited exemption amount is not justified using a *de minimis* rationale. Further, the Committee noted that “a dollar limitation would allow Congress to target the *de minimis* exception to taxpayers with relatively small amounts of rental income, which is more consistent with the *de minimis* rationale.”<sup>7</sup>

In the current proposal, taxpayers who have rental income greater than the \$2,000 *de minimis* amount would be required to take depreciation deductions for the rental period, though no specific legislative language was included in the proposal. Some past proposals, such as that suggested in the 105<sup>th</sup> Congress in H.R. 2621, the *Reciprocal Trade Agreement Authorities Act of 1997*,<sup>8</sup> would have provided a special rule which would have applied to those taxpayers who rent their homes for less than 15 days. The intent of that rule was to provide those taxpayers who had a short term rental the option to claim a depreciation deduction on the home. Current tax law provides that, for those taxpayers claiming depreciation for residential rental property, the straight line method based on a 27 ½ year period should be used. If no depreciation deduction was claimed, then the taxpayer would not need to adjust the basis of the house upon later sale.<sup>9</sup>

## Assessment

Economists believe that under a theoretically pure income tax, income should be defined as broadly as possible. Since current law excludes rental income for stays less than 15 days it understates income and, thus, does not tax income properly — at least according to a theoretically pure income tax. In contrast, proposals that include rental income in gross income and allow appropriate expenses provide for purer tax treatment.

If the proposal included a provision allowing the taxpayer the option of claiming a depreciation deduction, then economists would find that those taxpayers who forgo the depreciation deduction associated with the rental income would be overtaxed on that income by the amount attributable to depreciation and not deducted.

If the rule is included as was suggested by the Joint Committee on Taxation, those taxpayers required to take the allowable depreciation deduction would likely have extensive recordkeeping relative to the small deduction allowed, resulting in both high administrative expenses and increased tax code complexity. To claim depreciation,

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<sup>7</sup> Ibid. p. 58.

<sup>8</sup> H.R. 2621 was reported out of the House Ways and Means Committee but failed passage in the House.

<sup>9</sup> This special rule was contained in §301(e) of H.R. 2621. As drafted the bill stated that “If a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, the reduction under subsection (a)(2) by reason of such rental use in any taxable year beginning after December 31, 1997, shall not exceed the depreciation deduction allowed for such rental use... “ The courts have traditionally held that, while a taxpayer may choose not to avail themselves of a depreciation deduction, if that deduction is *allowable*, then the property’s basis must reflect the allowable depreciation when sold. Technical changes were discussed with an agreement that the word taken for allowed would make the provision less ambiguous.

taxpayers must remove the value of land (not a depreciable amount) from the property's basis. The deduction is likely to be small because of the short rental period (up to 14 days out of a 365-day year) and the long depreciable period (27 ½ years). Further, those taxpayers taking the depreciation deduction would need to recapture and pay tax on any previously claimed depreciated amounts upon sale of the property. The administrative costs would be high not only for the individual taxpayer but also for the Internal Revenue Service. Considering the small dollar amounts involved, the tax provision is not likely to be cost effective. Thus, theoretically correct tax treatment would greatly increase complexity for taxpayers.<sup>10</sup>

Requiring the computation of depreciation could result in taxpayers deciding that the rental income was not sufficiently high to offset the accounting and tax preparation costs. However, if the proposal were to allow taxpayers to choose whether to take a deduction for depreciation and not require taxpayers to make a reduction in the basis of the property, then it would not increase tax complexity. It would, however, be counter to a pure income tax model.

Several arguments are made against exclusions in general. For example, some may argue that all income should be included in the tax base because it is the best measure of an individual's ability to pay taxes. Other arguments suggest that upper-income taxpayers receive a greater subsidy from exclusions than lower-income taxpayers because of the higher tax rate upper-income households face.

It appears unlikely that lower-income persons are more prone to rent their homes for a two-week period than those with higher-income. Because of the nature of special events or areas with limited accommodations where demand is high, it can be expected that the costs of accommodations will rise and likely be expensive. Again, news reports suggest that higher-income households are those seeking such accommodations and that their demands are for more luxurious accommodations more likely to be owned by higher income individuals.

It is unclear who benefits from the current tax law's exclusion of income from short term rentals. While unsubstantiated, news reports typically associate the provision's use with special events or locations. For example, homeowners in the Washington, DC area are reported to have rented their homes during President Bush's inauguration while homeowners in New Orleans' historic French Quarter have rental opportunities during the annual Mardi Gras period. Besides special events, the provision may benefit those living in areas with a tight supply of hotel rooms. Such areas are frequently in large cities with tourist sites. As an example, it is frequently difficult to find accommodations in New York City where hotels are often booked weeks in advance. News stories suggest that homeowners frequently use this tax-free rental income to pay for vacations in other areas while their own homes are being rented out.

Some may argue that owner occupied housing receives excessive benefits from tax provisions under current law. Besides having income tax deductions for interest expense

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<sup>10</sup> The Joint Committee on Taxation stated that "The burden of this additional basis calculation, however, is relatively small when weighed against the more accurate measurement of economic income for such taxpayers achieved by the proposal," p. 58.

and property taxes, economists argue that homeowners also have a tax exemption for the imputed rental value of their home. All of these tax incentives provide significant benefits for homeowners that are not available to renters. Of course, some might argue that home ownership is a worthwhile social goal that should be tax-favored.

In addition to the tax benefits previously mentioned, there is also an exclusion from capital gains taxation for principal residence home sales of up to \$250,000 for single taxpayers and \$500,000 for married couples. The favorable capital gains treatment of residences encourages investment in real estate as opposed to financial assets, which experience less favorable tax treatment. This preferential treatment of home ownership diverts capital away from other uses, including business investment.

Alternatively, it may be argued that the benefit of current law's exclusion for *de minimis* rental income may flow through to those renting accommodations in the form of lower rents.

Some may question whether taxpayers would report their short term residential rental income. To the extent that such payments are made in cash, it would be difficult for the Internal Revenue Service to monitor rental payments. The proposal does not mention if it includes income reporting requirements by rental agents.

## Revenue Effects

The Joint Committee on Taxation has estimated that if their proposal were to become law there would be an increase in federal income tax revenue, by approximately \$10 million each fiscal year.<sup>11</sup>

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<sup>11</sup> U.S. Congress, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, 109<sup>th</sup> Cong., 1<sup>st</sup> sess. (Washington: GPO, 2005), p. 425.