TAX ACCOUNTING REVIEW
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TAX ACCOUNTING GROUP
of Duane Morris LLP

Does Your Vacation Home Qualify as a Tax Shelter?

With summer upon us, it may be time to reconsider the use of your vacation home. Will it serve as a well-deserved "escape"? Can it be a place to relax with your family and friends? Does it qualify as a tax shelter? With the right tax planning, you can achieve all of the above.

If you are considering renting your vacation home for any (or all) of the summer season, you need to be aware of the complex tax rules involved, including the passive activity loss rules and the vacation home rules. Without proper planning, these rules may substantially limit the deductibility of rental expenses and mortgage interest and therefore increase your tax liability. With proper planning, however, you can not only enjoy your vacation home for personal purposes, but you can also reduce your tax liability for this year and future years.

Occasional Rental

The first rule to remember is also the simplest. If you rent your vacation home for less than 15 days in a tax year, none of the rental income is taxable. In effect, Uncle Sam will supplement your cash flow, tax-free. Although any directly related rental expenses for this less-than-15 days' rental period would not be deductible (insurance, utilities, repairs and maintenance, etc.), the deductibility of mortgage interest

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Deducting Business-Pleasure Travel Expenses While Away From Home

Summer travel plans make now a good time to briefly discuss the rules for deducting the cost of out-of-town business travel expenses both inside and outside the United States. Keep in mind that the rules apply similarly to employees and self-employed persons, and that these rules apply only if the business conducted out of town reasonably requires an overnight stay.

Travel Within the United States

The actual costs of travel (*e.g.*, cab to airport, plane fare, etc.) are deductible for out-of-town business trips. The cost of meals and lodging is also deductible. Meals are deductible even if they are "personal" (*i.e.*, not connected with business, although, as with all deductible meals, only 50 percent of the cost is allowed). However, no deduction will be allowed for meals or lodging to the extent the expense is "lavish or extravagant."

Although personal entertainment costs on the trip are not deductible, business-related costs such as dry-cleaning, telephone and fax services, public stenographers and computer rentals are permitted. Allocations may be required if the trip is a combined business/pleasure trip, for example, flying to a location for five days of business meetings and staying on for an additional period of vacation. Only the cost of meals, lodging, etc., for the business days is deductible. Expenses for the personal vacation days are not deductible.

Conversely, with respect to the cost of the travel itself (plane or rail fares), if the trip is "primarily" business, it can be deducted in its entirety and no allocation is required. On the other hand, if the trip is primarily personal, none of the travel costs are deductible. An important factor in determining whether or not the trip is primarily business or personal is the amount of time allocated to each, although other factors may also come into play.

For trips that do not involve the actual conduct of business but are for the purpose of attending a convention, seminar or similar event, the IRS may investigate the nature of the meetings to ensure they are not vacations in disguise.

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and real estate taxes on the property, typically the highest expenses associated with real estate, would remain unaffected by the brief rental period.

Occasional Personal Use

Now let's go to the other extreme. If your *personal* use of your vacation home does not exceed the greater of 14 days per year or 10 percent of the number of days for which the home is rented, the home qualifies as a rental property subject to the *passive activity loss rules* and not as a second residence.

For example, Wayne owns a vacation property. During 2008, Wayne will use the property for personal purposes for 25 days and will rent the property for 300 days. Since the 25 days that Wayne will use the home does not exceed 10 percent of the rental days (300 multiplied by 10 percent equals 30 personal days), the home qualifies as a rental property.

The tax consequences and benefits of such occasional personal use are as follows. First, all of the rental income must be reported. The various expenses attributable to the rental, such as depreciation, insurance, repairs and maintenance and utilities, are deductible. Any of these expenses attributable to personal use are disallowed. However, all of these deductions are limited to the amount of income generated by this and other passive investments, assuming your modified adjusted gross income ("MAGI") is greater than $150,000.

In general, if you do not have sufficient passive income to offset these expenses, your rental losses are "suspended" until either you have sufficient passive income or you dispose of the property in a taxable transaction. If your MAGI is less than $150,000, a portion of the losses may be currently deductible against other income, and if your MAGI is less than $100,000, the loss is fully deductible currently.

One of the major pitfalls of having your home classified as a rental property, as opposed to a vacation home, is the manner in which mortgage interest is treated. Mortgage interest is often the largest deduction associated with the ownership of the property. While many taxpayers correctly assume that mortgage interest is deductible (assuming the various federal tax requirements regarding debt limitations are met) for both a primary residence as well as for a second residence, (1) mortgage interest may not be currently deductible if your home is considered a rental property; and (2) mortgage interest attributable to personal use will not be deductible.

Substantial Personal Use

If your vacation home is not used exclusively as a personal residence (*i.e.*, it is rented more than 14 days a year), but the house is personally used more than 14 days or 10 percent of the days actually rented, the home would be subject to the *vacation home rules*. In this case, you may continue to deduct rental expenses based on the rental use percentage, but only up to the "net profit" you derive from renting the property. "Net profit" means gross rental income less otherwise allowable deductions (*i.e.*, property taxes and mortgage interest that are deductible regardless of whether or not the property is rented). Moreover, your expenses must be subtracted from rental income in the following order: (1) interest, property taxes and casualty losses; (2) most other expenses except depreciation; and (3) depreciation. Any deductions that exceed gross income may be carried forward to be deducted against rental income in future years, subject to the same gross income limit.

It is important to note that the difference between the deductibility of expenses for a property subject to the passive activity loss rules (the "occasional personal use" treatment described above) and a property subject to the vacation home rules (the "substantial personal use" treatment described here) is that, in general, expenses incurred in the passive activity loss scenario will ultimately be deductible (on disposition of the property or when there is net passive income), while, for the substantial personal use scenario, expenses will be deductible **only** when gross rental income, in one year, exceeds that year's expenses, plus prior years' excess expenses. Disposing of the vacation home property will not make the prior years' excess expenses deductible. In other words, if the substantial personal use scenario applies, many expenses may **never** be deductible.

In order to determine the amount of expenses that may be used to offset rental income, you must allocate expenses between personal use and rental use. Unfortunately, and not surprisingly, the Tax Court and the IRS disagree as to the proper allocation method.

The Tax Court's more generous method, as reflected in the 1981 *Bolton* decision, allocates mortgage interest and property taxes in accordance with the ratio of total number of days of rental use to the total number of days in the year, whereas the IRS method allocates all expenses based upon the ratio of the number of days of rental use to the total number of days of personal and rental occupancy. For example, assuming the property was owned for the entire year, and was rented for 55 days and used personally for 184

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days, the Tax Court's method would allocate 15 percent (55 days divided by 366 days) of the mortgage interest and property taxes against rental income, while the IRS method would allocate 23 percent (55 days divided by 239 days of personal and rental occupancy) of the mortgage interest and property taxes against rental income. The Tax Court's method generally results in a much smaller amount of rental income being offset by mortgage interest and property taxes, leaving more income to be offset by other rental expenses (that would otherwise be nondeductible) and also resulting in a greater mortgage interest and property taxes deduction on Schedule A, Itemized Deductions, which further reduces the individual's tax liability.

Conclusion

Due to the complexity of the passive activity loss rules and the vacation home rules, special care must be taken to balance personal and rental usage of the property so that the most advantageous set of rules and elections applies. Furthermore, you should expect to spend a substantial amount of time assessing your personal and rental usage of the property, once rented. Moreover, if the purpose of your vacation home is to generate the greatest amount of tax benefits, you should invest a fair amount of time to document the amount of your expenses. We would be happy to meet with you to provide you with an effective tax strategy plan. |||

Deducting Business-Pleasure Travel Expenses (continued from page 1)

No deduction is allowed for the travel expenses of a spouse, dependent or other individual who accompanies the taxpayer or employee on a business trip unless such person is an employee of the person who is paying or reimbursing the expenses, the travel of such person serves a bona fide business purpose and the expenses of such person are otherwise deductible.

Travel Outside the United States

All of the travel costs, plus meals (at 50 percent), lodging and some incidental costs, such as for laundry and dry-cleaning, are deductible for foreign business trips that are entirely business related. For primarily personal trips, none of the costs of travel to and from the destination are deductible, even if some time is spent on business, although lodging, meals and entertainment would be deductible for the business days.

The rules are more complex when a trip is primarily, but not exclusively, for business. In this case, unless an exception applies as discussed below, the costs allocable to the personal (vacation) part of the trip cannot be deducted. For example, if the trip covers 10 days – three personal and seven business – meals, lodging, etc., are deductible only for the business days. Furthermore, only 70 percent of the travel costs are deductible, reflecting the fact that only 70 percent of the days of the trip were business days.

The allocation of travel expenses between personal and business purposes is **not** required if the primary purpose of the trip is business **and** the trip does not last for more than a week. A week for this purpose means seven consecutive days, not counting the day of departure, but counting the day of return. For example, if the taxpayer leaves on Sunday, May 4, and returns on Sunday, May 11, the trip did not last for more than a week. Additionally, even if the trip does last for more than a week, no allocation is required if the personal days total less than 25 percent of the total days spent on the trip. For this purpose, the total days of the trip include the day of departure and the day of return. If business is conducted on only part of a day, it is counted as a business day. Business days can include weekend days or holidays falling between two business days and days spent traveling to or from a business destination.

Example: *Dorothy flies to Paris on Monday, May 1 primarily for business reasons. She spends Tuesday on business, Wednesday and Thursday vacationing and Friday and the following Monday through Thursday on business before flying home Friday, May 12. Counting the days of return and departure, it is a 12-day trip. Only the first Wednesday and Thursday are nonbusiness days. Thus, less than 25 percent of the trip is personal (two of 12 days). Except for meals and lodging costs for those two vacation*

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days, the rest of the meals (at 50 percent) and lodging as well as all of the travel costs are deductible. The travel costs need not be allocated between business and personal because of the 25-percent rule. If the trip lasted eight days and two of the eight days (25 percent) were personal, then the travel costs would need to be allocated between business and personal.

If the one-week or 25-percent tests noted above are not satisfied, all of the travel costs may still be deductible if the taxpayer can show that the chance to take a vacation was not a major consideration for the trip. Of course, the larger the vacation portion, the more difficult it will be to support this position.

Conclusion

Whether travel is strictly business related or is a combination of business and pleasure, it is important to be thorough in preparing and maintaining adequate documentation that establishes the business or professional nature of the travel, since the burden is on the taxpayer to prove the business purpose of the travel.

The tax implications and record-keeping requirements of travel, particularly foreign travel, can get quite complex, depending on the nature of the trip. If you would like to discuss the complexities further, or would like us to review your planned domestic or foreign travel from a tax point of view, please do not hesitate to contact us. |||

Can You Take Advantage of the Favorable Like-Kind Exchange Provisions For Rental Properties With Personal Use?

A frequent question we receive from our clients is whether vacation homes that have been both rented out and used for personal purposes (also known as mixed-use properties) can be swapped in a tax-deferred Section 1031 like-kind exchange. Until recently, there was no clear answer.

The general rule provides that only business or investment property may be exchanged, on a tax-deferred basis, for other like-kind property that will also be held for business or investment purposes. Otherwise, Section 1031 exchange treatment is not permitted. Unfortunately, it was not clear whether a mixed-use vacation property could qualify as being held for business or investment purposes.

Some taxpayers took advantage of this ambiguity by aggressively claiming Section 1031 tax-deferral treatment for mixed-use vacation homes exchanged for similar mixed-use vacation homes. Fortunately for those taxpayers, and assuming the requirements explained below have been complied with, that treatment was correct! The IRS recently ratified the strategy in *Rev. Proc. 2008-16*. Naturally, as with any IRS procedure, this good news comes with some limitations, as noted below.

New Safe Harbor Provisions

First and foremost, keep in mind on the one hand that a property that has been used (or will be used) only as a personal residence cannot qualify for tax-deferred Section 1031 exchange treatment. On the other hand, a property that has been rented out and also used, to a limited extent, as a personal residence (or will be used in such a fashion) can qualify under the new safe harbor established by the IRS and effective March 10, 2008. To be eligible for the safe harbor, both the relinquished and replacement properties must meet certain rules.

Relinquished Property Rules

The property given up by the taxpayer ("the relinquished property") in the Section 1031 exchange must meet both of the following requirements.

1. It must have been owned by the taxpayer for at least 24 months immediately before the exchange; and

2. Within **each** of the two 12-month periods that constitute the entire 24-month period immediately before the exchange: (a) the property must have been rented at fair

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market value for at least 14 days, and (b) the taxpayer's personal use of the property cannot have exceeded the greater of 14 days or 10 percent of the days the property was rented at fair market value. Therefore, as long as the taxpayer's personal use of the relinquished property is 14 days or less, this second requirement has been met.

In terms of the two 12-month periods, the most recent 12-month period ends on the day *before* the exchange takes place and begins 12 months prior to that day. The earlier 12-month period ends on the day *before* the most recent 12-month period begins and begins 12 months prior to that day. For example, for a property exchanged on May 1, 2008, the most recent 12-month period ends on April 30, 2008, and begins May 1, 2007, and the earlier 12-month period ends on April 30, 2007, and begins May 1, 2006.

Replacement Property Rules

The replacement property (the property acquired by the taxpayer in the Section 1031 exchange) must meet both of the following requirements.

1. It must be continually owned by the taxpayer for at least 24 months immediately after the exchange; and

2. Within **each** of the two 12-month periods that constitute the 24 months immediately after the exchange: (a) the property must be rented at fair market value for at least 14 days, and (b) the taxpayer's personal use of the property cannot exceed the greater of 14 days or 10 percent of the days the property is rented at market rates. Again, as noted above with regard to the property given up by the taxpayer, as long as the taxpayer's personal use of the replacement property is 14 days or less, this second requirement will be met.

For purposes of the replacement property rules, the first 12-month period begins on the day *after* the exchange takes place and ends 12 months after that day. The second 12-month period begins on the day *after* the end of the first 12-month period and ends 12 months later. For example, for a property acquired by the taxpayer on May 1, 2008, the first 12-month period begins on May 2, 2008, and ends May 1, 2009, and the second 12-month period begins on May 2, 2009, and ends May 1, 2010.

Personal Use Defined

Excessive personal use of either exchange property will breach the safe-harbor rules. The IRS has stated that a taxpayer personal-use day occurs whenever the property is used for **any** part of the day:

1. For personal purposes by the taxpayer or by anyone else who has an interest in the property.

2. By a family member of the taxpayer or a family member of anyone else who has an interest in the property.

3. By any individual under an arrangement that allows the taxpayer to use some other property (regardless of whether or not the taxpayer pays fair market value rent for using the other property).

4. By any individual who pays less than fair market value rent.

One notable exception to the personal use rules is that the use of the property as the **principal residence** of anyone (including a family member) who pays fair market value rent is not considered personal use by the taxpayer.

Eligible Properties

To qualify for the new safe-harbor provisions a property must be a dwelling unit, *i.e.*, real property that is improved with an apartment, condominium, house or similar improvement that provides basic living accommodations, including sleeping space and bathroom and cooking facilities. It is questionable whether or not a lot with a trailer home would qualify; however, a plot of land that includes only an outdoor camping site would not qualify. Until the IRS issues additional guidance, we recommend a conservative approach.

Tax Filing Implications

If a taxpayer reports a Section 1031 tax-deferred exchange under the new safe-harbor provisions but later fails the replacement property requirements described above, the taxpayer would then need to file an amended return for the year of the exchange and report it as a taxable transaction. As explained above, this may be unknown until late in the second year of ownership of the replacement property, so interest and penalties may also apply. Therefore, it is important to keep in mind the replacement property requirements after the exchange has occurred.

Conclusion

Although *Rev. Proc. 2008-16* may not provide everything that a taxpayer contemplating a like-kind exchange of mixed-use property could hope for, it does provide some clarity and tax benefits. Please contact us if you have any questions regarding your personal situation. |||

New Legislation May Provide Relief From Home Mortgage Debt Discharge Income

Federal tax legislation passed late in 2007 provides some relief for homeowners caught in the mortgage credit crunch. Individuals who purchased their homes when values were at or near their peak and sell their homes in 2008 for less than their outstanding mortgage debt, or worse yet have their homes foreclosed upon, may have debt discharge income (DDI), which results when a mortgage lender forgives some or all of a loan balance. However, a favorable provision included in the *Mortgage Forgiveness Debt Relief Act* of 2007 (the "Mortgage Relief Act") may provide some relief to these individuals, but only for years 2007 through 2009.

New Exception for DDI from Principal Residence Mortgages

Unless an exception applies, DDI is generally taxable income to the borrowers. The Mortgage Relief Act created a new exception for certain discharges of home mortgage debt that occur in calendar years 2007 through 2009. The new exception allows an eligible homeowner to exclude from gross income up to $2 million of DDI from "qualified principal residence indebtedness," which is debt that meets the definition of "acquisition indebtedness" on the taxpayer's principal residence. The exclusion is limited to $2 million of debt ($1 million limit for a married individual who files separately).

Acquisition indebtedness for a principal residence means debt that is incurred in the acquisition, construction or substantial improvement of an individual's principal residence and that is secured by that residence. It also includes refinanced debt to the extent the refinanced amount does not exceed the amount of refinanced acquisition indebtedness.

Observation: *As noted above, the new exception applies only with respect to debt that is used to acquire, construct or improve the taxpayer's* ***principal*** *residence. Therefore, it will not help with DDI from home equity loans that were used for other purposes nor will it help with DDI from vacation home mortgages. It will help only those who borrowed too much to acquire, build or improve a principal residence.*

If there is DDI from a loan where only part of the loan is qualified principal residence indebtedness, the exception applies only to the part of the discharged debt that is related to the qualified principal residence indebtedness.

Additionally, the exception does not apply to DDI if the discharge is: (1) on account of services performed for the lender; (2) on account of any other factor not directly related to a decline in the value of the residence or to the taxpayer's financial condition; or (3) to a taxpayer in a Title 11 bankruptcy case. An insolvent taxpayer who is not in a Title 11 bankruptcy case can elect to have the new DDI exception not apply and instead rely on other more generous insolvency provisions.

Example of Excluded DDI

Rhett and Scarlett, a married joint-filing couple, overpaid for their principal residence when local property values were skyrocketing. In 2008, the market collapsed, Rhett lost his job, and the home was foreclosed on. The property had an $850,000 recourse first mortgage, all of which qualified as acquisition indebtedness.

The first $550,000 of the mortgage was paid off when the bank sold the property in a distress sale. Rhett and Scarlett came up with $30,000 to extinguish part of the remaining balance, and the lender forgave the last $270,000 in April 2008.

Due to the new provision in the Mortgage Relief Act, Rhett and Scarlett can exclude the $270,000 of DDI from their gross income. To evidence this fact, they should file a special IRS form with their 2008 Form 1040. On the special IRS form, the $270,000 DDI amount and the required $270,000 basis reduction should be reported.

If the tax basis of their home before the foreclosure was $925,000, after reducing it for the $270,000, their adjusted basis will be $655,000. Assuming the $550,000 distress sale price collected by the lender represents the home's fair market value, Rhett and Scarlett have a $105,000 nondeductible loss on sale ($550,000 sale price – $655,000 basis). Keep in mind that without the new DDI provision, Rhett and Scarlett would have had to recognize $270,000 of DDI, and their nondeductible personal loss would have been $375,000 ($550,000 – $925,000).

Relief May Still Be Available Even If the New DDI Exception Does Not Apply

In the event the new legislation does not apply, other Internal Revenue Code provisions may provide allowable exceptions to the general rule that DDI must be included in the borrower's gross income. A full explanation of these

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other provisions is beyond the scope of this discussion; however, these provisions include situations where (1) the forgiven debt includes unpaid interest, (2) the borrower is bankrupt or insolvent when debt forgiveness occurs, (3) the forgiven debt is seller financing, or (4) the forgiven debt is real property business or farm debt.

Conclusion

While this new DDI exception offers substantial tax relief for individuals who have to sell their homes for less than their outstanding mortgage debt and for those who have had their homes foreclosed, you should confirm the tax implications prior to the debt discharge. If you would like to discuss these rules further, please feel free to contact us. |||

TAX ACCOUNTING GROUP NEWS

The **Tax Accounting Group** welcomes **Brian Adams**, CPA. As a Manager, Brian brings over a decade of business and individual tax planning and compliance experience working with both international and large regional CPA firms. Brian also has experience at the management level in a large, international organization in the financial services industry. Brian's practice will focus on the areas of federal, state and local taxation, with particular emphasis on income tax planning and compliance for businesses and high net worth individuals.

The **Tax Accounting Group** welcomes **Michael Bartosik**, CPA, CFP as tax manager. Michael has over a dozen years of experience in many facets of federal, state and local income taxation, accounting and auditing and personal financial planning. His practice will primarily focus on tax compliance and planning, as well as tax related matters for a diverse client base, including closely-held businesses, multi-state corporations and partnerships and high net worth individuals.

Barbara Ruth and Michael Gillen authored an article "Lack of Planning Can Result in Poor Settlements", which was published in *The Legal Intelligencer* on March 4, 2008.

Steven Packer and Michael Gillen authored an article "When Tax Liabilities Can't Be Paid – Risks, Ramifications and Resolutions", which was published in *The Legal Intelligencer* on April 1, 2008.

Steven Packer received the Champion Award from the Greater Philadelphia Chapter of the Pennsylvania Institute of Certified Public Accountants (PICPA) for exemplifying the highest qualities of leadership through distinguished participation, contributions and commitment to the Institute, CPA profession, and community.

Michael Gillen was a guest speaker on CN8's "Money Matters Today" television program in January 2008 to discuss ways to jump-start tax preparation. He appeared again in March 2008 to comment on the breaking news regarding KPMG audits of New Century Financial and the allegations that KPMG helped the troubled mortgage company devise accounting strategies to hide the problems that led to its collapse last April. He also discussed the upcoming Economic Stimulus tax rebate payments together with last-minute tax tips.

Various members of the Tax Accounting Group have successfully represented existing and new clients before the Examination, Collection and Appeals Divisions of the IRS as well as state and local taxing authorities. Recent successes include:

- Represented a decedent before the Examination Division of the IRS resulting in an income tax savings of more than $100,000.
- Represented a retiree before the Collection Division of the IRS and arranged the elimination of about $35,000 in income tax resulting from an erroneous assessment made by the IRS.
- Represented a golf course before the Collection Division of the IRS and negotiated the abatement of a civil tax penalty of more than $14,000 as a result of the failure to file required tax returns.
- Represented a supplier of communications systems and services before the Examination Division of the IRS and secured a "no change" income tax report.
- Represented a college professor of one of the most prestigious universities in Pennsylvania before the Examination Division of the IRS resulting in a "no change" income tax report.
- Represented a lawyer before the New York Department of Finance and Revenue resulting in a "no change" income tax report.
- Represented a seller of sports memorabilia before the Examination Division of the IRS and secured a "no change" income tax report.
- Represented an international law firm before the City of New York Tax Appeals Tribunal resulting in a reduction in New York City unincorporated business tax from $230,000 to $25,000.
- Represented an international law firm before the Chicago Department of Revenue and secured a "no change" sales tax report.

About Duane Morris

Duane Morris LLP, one of the 100 largest law firms in the world, is a full-service firm of more than 650 lawyers. In addition to legal services, Duane Morris has independent affiliates employing approximately 100 professionals engaged in other disciplines, such as the tax, accounting and litigation consulting practice of the Tax Accounting Group. With offices in major markets in the United States and internationally, Duane Morris represents clients across the U.S. and around the world. |||

About the Tax Accounting Group

The Tax Accounting Group, one of the largest groups of its kind affiliated with a law firm, has an active and diverse practice with more than 60 service lines in more than 45 industries, serving clients in 43 states and eight foreign countries. The Group's certified public accountants, certified fraud examiners, financial consultants and advisors provide a broad range of cost-effective tax preparation, planning and consulting services as well as accounting, financial and management advisory services to individuals, corporations, partnerships, estates and trusts, and nonprofit organizations.

The Group also provides an array of litigation consulting services to numerous lawyers and law firms representing clients in regulatory and transactional matters and throughout various stages of litigation. Consulting services include, but are not limited to, case assessment and strategy development; asset recovery investigation and locator services; damage assessment and measurement; marital disputes; forensic and investigative accounting; fraud and embezzlement detection; and civil and criminal tax controversies. |||

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