



# Before You Deduct a Loss From a Timeshare Rental, Read This

BY DAVID M. FOGEL, EA, CPA

From their origins in the ski resorts of the French Alps in the 1960s, timeshare ownership interests in vacation properties have become the fastest-growing segment in the travel industry<sup>1</sup>. Many owners of timeshares rent their units to tenants. Surprisingly, even if an owner of such a rental does not use the timeshare for personal use during the tax year, he or she is nearly always prevented by the provisions of Code section 280A from deducting a loss. This article explores the different ways that owners use their timeshares and the tax consequences of such uses.

## Introduction

The timeshare industry is redefining vacation travel. There is an ever-expanding choice of accommodations, amenities, locations, pricing, use plans, and timeshare exchange options. Vacations can be tailored to meet an individual's or family's lifestyle needs and travel dreams at more than 5,000 resorts in almost 100 countries around the world. Types of accommodations include a hotel room, studio, 1-bedroom, 2-bedroom, 3-bedroom, and combination units. In 2005, timeshare travelers spent an estimated \$10 billion during their U.S. timeshare vacations<sup>2</sup>.

The most common types of timeshare ownership are Fee Simple and Certificate. In Fee Simple Ownership, you purchase an interest — usually a week of use of a particular unit — in a resort, receive a deed for your purchase, and ownership is perpetual. Typically, developers will sell 50 weeks of ownership of a particular unit, leaving 2 weeks during the year for maintenance of that unit. In Certificate Ownership, your purchase entitles you to use a particular unit in a resort for a specific number of years, so that the arrangement is similar to a lease. Most timeshare purchases in the U.S. are Fee Simple Ownership,

while most timeshare purchases outside the U.S. are Certificate Ownership. For purposes of this article, I will assume a timeshare with Fee Simple Ownership.

## Typical Expenses Incurred Through Timeshare Ownership

The following are typical expenses that a client might incur as a result of owning an interest in a timeshare property.

### Interest Expense

A buyer will either pay for the timeshare interest in a lump sum or finance a portion of the purchase price with a loan. For those buyers who finance their purchase, interest paid on the mortgage loan is one type of expense. Most lenders do not like to finance timeshare purchases, so the term of the loan is usually not more than 5 or 10 years, and the interest rate is rather high — usually between 15% and 18%.

### Maintenance Fee

Most timeshare resorts charge an annual maintenance fee, typically from \$300 to \$600 depending upon the resort and the size of the unit.

### Real Estate Taxes

A portion of the maintenance fee includes real estate taxes, but this portion is usually very small. For example, a maintenance fee of \$500 might include only \$40 in real estate taxes.

### Exchange Fees

If the timeshare is exchanged for use of a unit in a different resort, then the buyer is usually required to pay an exchange fee as well as an annual fee for membership in the exchange club. For example, Resort Condominiums International



(“RCI”), one of the leading exchange companies, charges a fee of \$164 for a domestic 1-week exchange and \$199 for an international 1-week exchange<sup>3</sup>. In addition, RCI charges an \$89 annual membership fee.

**Rental Fee**

If the owner engages a rental company that rents the timeshare to tenants, the rental company will usually charge a rental fee, and this fee might range anywhere from a relatively small amount (e.g. \$35) to a larger amount (e.g. 15% of the rental income).

**Depreciation**

A fee simple ownership in a timeshare is considered an ownership interest in real estate. Accordingly, if the owner rents the timeshare to tenants, depreciation is computed under the Modified Accelerated Cost Recovery System (MACRS) using a 27.5-year recovery period<sup>4</sup>.

**Use Determines the Tax Consequences**

While the purchase of a timeshare interest can be relatively straightforward, there are many tax issues associated with timeshare ownership that are overlooked<sup>5</sup>.

There are basically three types of uses of a timeshare unit — personal use only (or exchange), rental use only, and a combination of personal and rental use. Each of these uses determines the tax consequences.

**Personal Use Only**

If a timeshare is utilized solely for personal (e.g. vacation) use, or if the timeshare is exchanged for a unit in a different resort, then the portion of the maintenance fee that represents

	Hawaii	Florida
Rental Income	\$ 600	\$1,100
<b>Rental Expenses:</b>		
Maintenance Fee	275	400
Real Estate Taxes	40	45
Rental Fee	35	155
Depreciation	450	900
<b>Total Rental Expenses</b>	<b>\$800</b>	<b>\$1,500</b>
<b>Net Loss</b>	<b>(\$200)</b>	<b>(\$400)</b>

real estate taxes is deductible as an itemized deduction. In addition, the interest paid on the mortgage loan may be deductible as interest paid on a second residence<sup>6</sup>.

**Rental Use Only**

If a timeshare is rented to tenants, then the tax consequences are quite a bit more complicated. You would think

that if the timeshare is rented, and there is no personal use, then the client would report the rental income, deduct all expenses including depreciation, and if the result is a net loss, the loss would be deductible. Unfortunately, it isn’t that simple.

The following hypothetical situation will illustrate the problem. Suppose that during 2003, a husband and wife purchased a 1-week timeshare interest in a condominium resort located in Hawaii, and a 2-week timeshare interest in a condominium resort located in Florida.

During the taxable year 2006, the taxpayers rented all three timeshare weeks to unrelated parties. The taxpayers did not use the timeshares personally and did not exchange their timeshares for any timeshares in a different resort. During 2006, the taxpayers received income and paid expenses relating to their rental activity as follows:

Also during 2006, among all of the persons who owned the other weeks of these timeshares, 10 weeks of the Hawaii timeshare, and 12 weeks of the Florida timeshare, were rented to tenants. Each of the units was not available for any use for 2 weeks of the year due to maintenance. The units were either personally used by their owners or by owners of other timeshares who obtained their weeks through an exchange program during the remaining weeks of the year (39 weeks for the Hawaii unit and 36 weeks for the Florida unit).

Code section 280A severely limits deductions with respect to a dwelling unit that is used by the taxpayer during the taxable year as a residence<sup>7</sup>. In relevant part, there are two rules that prevent a taxpayer from deducting a loss. First, no loss is deductible if the taxpayer uses the dwelling unit during the taxable year for personal purposes for the greater of 14 days or 10 percent of the number of days that the unit is rented at a fair rental<sup>8</sup>. Second, if the taxpayer uses the dwelling unit for personal purposes for any amount of time during the taxable year and the unit is rented for less than 15 days during the year, then no rental income is reportable and no rental expenses are deductible<sup>9</sup>.

In the above hypothetical situation, you might argue that neither of these two rules applies because the taxpayers did not use their timeshares for personal purposes at any time during the taxable year. However, section 280A contains some additional rules that must be considered.

Section 280A(f)(1) provides that the term “dwelling unit” includes a house, apartment, condominium, mobile home, boat, or similar property. Therefore, it refers to the “dwelling unit” as the condominium, not a particular week of use of that condominium.

Also, section 280A(d)(2) provides that the taxpayer shall be deemed to have used a dwelling unit for personal purposes for any day during which either the taxpayer, a person related to the taxpayer, or any other person who has

an interest in the unit uses the unit for personal purposes. This section also provides that personal use includes use of some other dwelling unit under an exchange arrangement. Therefore, personal use not only includes the taxpayer's use of the condominium, but also personal use by anyone else who owns a week of use of the condominium.

As a result, in applying the 14-day / 10 percent rule of section 280A(d)(1) regarding personal use, or the 15-day rule of section 280A(g) regarding rental use, you must take into account personal use and rental use by everyone who owns a timeshare interest in the particular unit of the resort. This was the Tax Court's conclusion in *Fudim v. Commissioner*<sup>10</sup>.

In our hypothetical situation, the taxpayer and the other owners rented the unit in Hawaii for a total of 11 weeks during the year, and they rented the unit in Florida for a total of 14 weeks during the year. Except for 2 weeks that the unit was unavailable due to maintenance, the Hawaii unit was used personally for 39 weeks during the year, and the Florida unit was used personally for 36 weeks during the year. The 39 and 36 weeks of use exceed the 14 days and 10 percent limitations described in section 280A(d)(1), and as a result, none of the owners are entitled to claim a loss from renting their timeshare interests. Also, since both units were rented for more than 15 days during the year, section 280A(g) does not apply.

So, what happens to the nondeductible \$200 and \$400 rental losses? Are they lost forever? Possibly. The losses carry over to the following year and are subjected to the section 280A limitations in that year<sup>11</sup>.

Personal Use and Rental Use. If a timeshare is used personally for a part of the year and rented for a part of the year, then in addition to the limitations described above under Rental Use Only, expenses must be allocated between personal use and rental use.

Under regulations proposed by the IRS<sup>12</sup>, timeshare owners are required to allocate expenses between personal use and rental use based on the uses by all the units' owners during the year (in other words, the personal and rental percentages will be the same for all timeshare owners)<sup>13</sup>.

Obviously, your client will probably not be able to obtain information about each owner's personal and rental use during the year. Two commentators have suggested that due to this problem, it would be reasonable to base the allocation percentages on your client's own use of the units during the year<sup>14</sup>.

In making the allocation of expenses between personal and rental use, the IRS allocates rental use based on actual total use rather than availability<sup>15</sup>. For example, if a taxpayer owns 4 weeks of a timeshare, rents 3 weeks and uses 1 week personally, the allocation to rental use is 3 weeks divided by 4 weeks, or 75 percent. However, the Tax Court, the Ninth and Tenth Federal Circuits allocate rental use based on availability rather than actual total use<sup>16</sup>. As a result, the allocation to rental use would be 3 weeks divided by 50 weeks, or 6 percent.

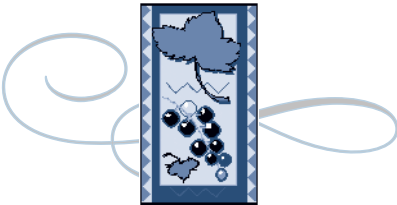
Since our clients probably reside in the Ninth Federal Circuit, we have an option to use either the IRS's allocation method or the court's method, whichever is most beneficial for our clients. Since it is unlikely that our clients

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will be able to deduct a rental loss, it is probably more beneficial to use the court’s allocation method since it results in a larger allocation of expenses to personal use, allowing our client to deduct more of the mortgage interest and real estate taxes as itemized deductions.

## Conclusion

It is unlikely that renting an interest in timeshare property to tenants will result in a deductible loss, even if your client does not have any personal or vacation use of that timeshare. Accordingly, if your client asks you to claim a loss on the tax return from renting the timeshare, you may need to explain to your client the rules that prevent the loss deduction. ◀

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<sup>1</sup> “Rediscovering Timeshares,” RTKL Associates, Inc., [www.rtkl.com](http://www.rtkl.com).  
<sup>2</sup> “Understanding Vacation Ownership,” American Resort Development Association, [www.arda.org](http://www.arda.org).  
<sup>3</sup> “RCI Weeks Transaction Fees,” [www.rci.com](http://www.rci.com).

<sup>4</sup> An allocation should be made to eliminate the portion of the cost basis that is allocable to non-depreciable land.  
<sup>5</sup> Craig & Luttman, “Taxation of Timeshares – Acquisition, Use and Disposition Issues,” 27 *Journal of Real Estate Taxation* 301 (Warren, Gorham & Lamont, 2000).  
<sup>6</sup> See I.R.C. §163(h)(4)(A)(iii).  
<sup>7</sup> I.R.C. §280A(a).  
<sup>8</sup> I.R.C. §280A(d)(1) and (c)(5).  
<sup>9</sup> I.R.C. §280(g).  
<sup>10</sup> In *Fudim v. Commissioner*, T.C. Memo. 1994-235, taxpayers were not allowed to deduct losses from renting their two timeshares, despite their having no personal use, because they were unable to prove that there was less than 14 days or less than 10% personal use of the unit by the other persons who owned weeks in the timeshare.  
<sup>11</sup> See the last paragraph of I.R.C. §280A(c)(5).  
<sup>12</sup> Regulations under I.R.C. §280A were proposed 8/7/80, amended 7/21/83, partially withdrawn 5/20/94, and are still in proposed form. Proposed regulations carry no greater weight than a position advanced by the IRS. However, they may be useful as guidelines where they closely follow the legislative history. *Estate of Wallace v. Commissioner*, 95 T.C. 525, 547 (1990), aff’d. 965 F.2d 1038 (11th Cir. 1992); *Miller v. Commissioner*, 70 T.C. 448, 460 (1978); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970)).  
<sup>13</sup> See Prop. Reg. §1.280A-3(f)(5), which states:  
 (5) Allocation rule. The provisions of paragraph (c) of this section shall apply if any person with an interest in the unit is deemed to use the unit for personal purposes on any day during the taxable year. The provisions of paragraph (c) of this section shall be applied on the basis of the taxpayer’s expenses for the unit, the number of days during the taxable year that the unit is rented at a fair rental, and the number of days during the taxable year that the unit is used for any purpose.  
<sup>14</sup> Craig & Luttman, *supra*, note 4; Ellentuck, “Owning and Renting Timeshares. (Case Study),” 2 *The Tax Adviser* 385 (AICPA, Nov. 1, 2002).  
<sup>15</sup> Prop. Reg. §1.280A-3(f)(5) (footnote 10).  
<sup>16</sup> See, e.g., *Bolton v. Commissioner*, 694 F.2d 556 (9th Cir. 1983) and *McKinney v. Commissioner*, 721 F.2d 163 (10th Cir. 1983).

## YOU Be the Judge

*This exciting feature showcases real situations and ethics problems torn from the pages of today’s headlines. Here is the problem; read it, think about, and then turn to page 20 for the answer.*

A tax preparer and his associates prepared numerous income tax returns that claimed false business deductions and one of the associates promoted, sold and managed domestic trusts used by clients to hide their income and assets from the IRS. The tax preparer and his associates also evaded taxes on their own income. These tax evasion schemes resulted in a tax loss to the United States of more than \$1 million.



What punishment should the preparer and associates receive?

- A) Tax preparer pays the unpaid liability and the associates receive jail sentences.
- B) Tax preparer receives a jail sentence, pays some restitution and the associates pay a penalty.
- C) Tax preparer receives a jail sentence, pays some restitution and the associates receive jail sentences.
- D) None of the above.