POTENTIAL TAX ADVANTAGES WITH SHORT TERM RENTAL INVESTMENTS

First, it's important to realize there are four (4) types of short-term rental properties:

- **"Business" short-term rentals, with Material Participation**
- **"Business" short-term rentals, WITHOUT Material Participation**
- **Passive short-term rentals, with Material Participation**
- **Passive short-term rentals, WITHOUT Material Participation**

Next, all four of these classifications depend on the following three (3) factors. They will directly impact how your short-term rentals are taxed.

7 TESTS OF MATERIAL PARTICIPATION

- The individual participates in the activity for more than 500 hours during the year.
- The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.
- The individual participates in the activity for more than 100 hours during the taxable year, and such an individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.
- The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.
- The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.
- The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
- Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such a year.

Short-Term Rental Tax Reporting Matrix

Substantial Services

Less then 7-day Avg. Stay				
	Yes	*Yes- "Material Participation"* Schedule C and subject to SE Tax or (S-corp Strategy) **BUT...You get Pass-thru Losses & Cost-Seg Option**	*No- "Material Participation"* Schedule C adn subject to SE Tax or (S-corp Strategy) **BUT...You get Pass-thru Losses & Cost-Seg Option**	*Yes- "Material Participation"* Schedule E (No SE Tax) **BUT...You get Pass-thru Losses & Cost-Seg Option** *"Best of All Worlds"*
	No	*No- "Material Participation"* Schedule C and subject to SE Tax or (S-corp Strategy) *"Worst of All Worlds"*	*No- "Material Participation"* Schedule E (No SE Tax) Treated like a regular Long-Term Rental	

1. AVERAGE RENTAL DAYS A TENANT OR PATRON STAYS AT THE PROPERTY

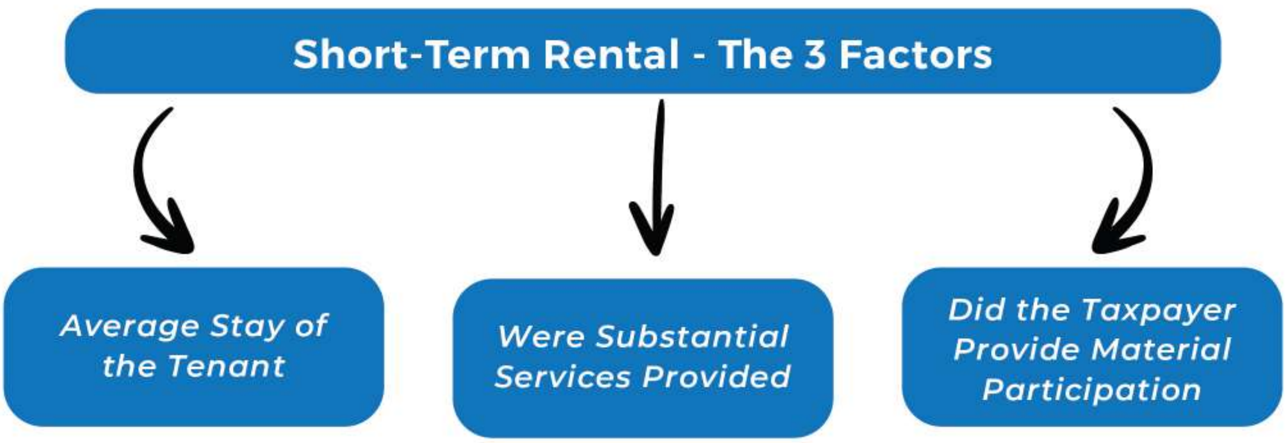
The first factor to consider is the average stay at your rental property. In addition to whether or not it's for less than seven days. The seven-day-or-less rule applies with the 'average stay duration' taken over a year's time. Essentially, you will divide your rental days by the number of renters.

EXAMPLE: Assume you rented out your cabin 21 times (the renters) during the year for a total of 108 days. One would take 108 divided by the 21 renters. Thus, your average rental is 5.14 days (108/21) and falls into the less than seven-day rental category.

IF the average stay is less than 7 days – You may report the operations on Schedule E (just like a typical long-term rental) and the income is NOT subject to Self-Employment Tax (FICA)…ALSO, you open the opportunity for Ordinary Loss Treatment if you can show Material Participation (see below).

IF the average stay is MORE than 7 days – Not all is lost, the operations you need to report on a Schedule E (just like a typical long-term rental). The income is NOT subject to Self-Employment Tax (FICA)…BUT Ordinary Loss Treatment is not available to you EVEN IF you can show Material Participation (see below).

The next level of analysis comes down to the type of service you provide for the tenant while they're staying at your property; i.e. whether or not it's considered a substantial service. There are pros and cons to providing substantial services. It can affect your rental rates as well as the tax consequences.



2. SUBSTANTIAL SERVICES AND A “BUSINESS” SHORT-TERM RENTAL

The IRS has deemed that if you provide substantial services to your guests, then the income you make needs to be reported on a Schedule C, the end. This essentially means you have a “Business Short-term Rental”. You’ve elevated your activity to that of a business (think of it like a hotel).

IF you provide Substantial Services – You must report the operations on Schedule C and the net-income is subject to Self Employment Tax, and your only salvation would be to implement an S-Corporation to mitigate the FICA tax. ALSO BEWARE! This does not mean you get Ordinary Loss Treatment…you still MUST show Material Participation (see below).

IF you DON’T provide Substantial Services – You may report the operations on Schedule E (just like a typical long-term rental) and the income is NOT subject to Self-Employment Tax (FICA)…ALSO, you STILL have the opportunity for Ordinary Loss Treatment if you can show Material Participation (see below).

EXAMPLES OF SUBSTANTIAL SERVICES:

- **Cleaning of the rental each day while the property is occupied by the same guests.**
- **Changing bed sheets and other linens each day while the property is occupied by the same guests.**
- **Concierge services.**
- **Conducting guest tours and outings.**
- **Providing meals and entertainment (like providing breakfast each morning).**
- **Providing transportation.**
- **Providing other “hotel-like” services.**

Regrettably, the IRS hasn’t provided much guidance other than the few items above. There aren’t any court cases, Revenue Rulings, or Treasury Regs on this topic. We expect to have more clarity on what constitutes ‘substantial services’ in the near future.

But a word of caution. I know some educators on this suggest aggressive tactics to provide more benefits for your tenants in order to increase demand for your property and even daily rates, but be careful not to get too close to meeting the definition of substantial services – the tax result could be devastating.

3. “PERSONALLY” SERVING WITH MATERIAL PARTICIPATION

This is where things get interesting. Typically, in order to take flow-thru passive rental losses as ordinary losses, one has to qualify as a real estate professional. However, under essentially ‘outdated’ Treasury Regulations (that were put in place by the IRS far before the onset of the ‘Airbnb’ concept, there is a unique loophole related to how short-term rentals are taxed.

Under this seemingly aggressive provision, if an owner can show personal material participation. That way then the rental losses on a short-term rental “morph” into ordinary losses.

In order to qualify as Materially Participating in the operations of your rental, a taxpayer must meet (1) of the following (7) tests. NOT ALL 7, but just one. We have found over the years that clients generally find it easier to qualify under tests 1, 2, or 3 (highlighted in ‘red’ below). Here are the tests directly quoted from the IRS code:

HOW IT WORKS

Again, by qualifying under one of the tests above, essentially any net-loss on the operations of the property is considered an ordinary loss and is also deductible against any other income as an above-the-line deduction on your tax return.

This is where investors (that qualify) discover the power of utilizing a ‘Cost Segregation Analysis’ and dramatically increasing the depreciation deduction in the first year they place the property in service.

However, as I stated above, in order to capitalize on this strategy a taxpayer is relying on an IRS Code Section and Treas. Reg. that is clearly out of date. Now, I find nothing wrong with using a loophole until it’s shut…I just don’t want to be the one (or my client) that gets their hand caught in the door when they shut it. Most CPAs agree that by taking these passive losses when their client isn’t a real estate professional, it could trigger an audit. Be careful.

THE SHORT-TERM RENTAL TAXATION MATRIX

To help simplify the analysis when considering the 4 types of short-term rentals and the 3 phases of analysis, I created the following matrix. Hopefully, this assists you in your decision-making for yourself, and/or your clients

COST SEGREGATION

UNDERSTANDING COST SEGREGATION AND ITS TAX BENEFITS FOR SHORT-TERM RENTAL (STR) INVESTORS

Cost segregation is a tax strategy that allows real estate investors to accelerate depreciation deductions by reclassifying certain components of a property. This technique breaks down the property into various assets with shorter depreciation schedules, enabling investors to defer taxes and improve cash flow.

WHAT IS COST SEGREGATION?

When a property is purchased, it is typically depreciated over a standard period-27.5 years for residential properties and 39 years for commercial properties. However, cost segregation identifies and separates components of the property (e.g., flooring, lighting, landscaping, HVAC systems) that can be classified as personal property or land improvements. These items are then depreciated over much shorter periods, typically 5, 7, or 15 years, rather than the standard schedule.

HOW COST SEGREGATION WORKS

Property Analysis: A specialized engineering study is conducted to analyze the property and categorize its components into shorter depreciation schedules.

Reclassification: Components such as carpets, cabinetry, driveways, and certain electrical systems are reclassified.

Accelerated Depreciation: The reclassified components are depreciated more quickly, resulting in larger tax deductions in the early years of ownership.

TAX BENEFITS FOR STR INVESTORS

Immediate Tax Savings: By accelerating depreciation, investors can significantly reduce taxable income in the early years of owning the property.

Bonus Depreciation: Under current tax laws, assets with a useful life of 20 years or less qualify for 100% bonus depreciation in the year they are placed in service. This allows investors to deduct the full cost of these components in the first year, creating substantial tax savings.

Improved Cash Flow: Reduced tax liabilities mean more cash remains in your pocket, which can be reinvested into additional properties or used for other purposes.

Offset Active Income: For investors who qualify as real estate professionals or who materially participate in managing their STRs, cost segregation deductions can offset active income, further increasing tax savings.

Flexibility in Planning: Cost segregation provides a strategic advantage in managing tax obligations, allowing investors to defer taxes and plan their finances more effectively.

IS COST SEGREGATION RIGHT FOR YOU?

Cost segregation studies are most beneficial for high-value properties or newly purchased properties where the potential tax savings outweigh the cost of the study. For STR investors, this strategy can significantly enhance the profitability of your investment by reducing tax liabilities and increasing liquidity.

EXAMPLE:

If an investor purchases a $500,000 STR property, a cost segregation study might identify $100,000 worth of components eligible for 5-year depreciation and $50,000 for 15-year depreciation. Using bonus depreciation, the investor could deduct $150,000 in the first year, drastically lowering taxable income and increasing immediate cash flow.

Consult with a tax advisor or cost segregation specialist to determine whether this strategy aligns with your investment goals and tax situation.