Helping your financially challenged family members by renting them a property can be fraught with tax perils.

A misstep can lead to the loss of significant tax deductions. Here's a look at the tax treatment that applies when you rent to unrelated parties and how the rules change when you rent to relatives.

Business vs. Personal

If you use real estate as a rental property strictly for business purposes, you must report the income. You can also deduct mortgage interest, property taxes, utilities, depreciation, maintenance, and other expenses. If your expenses exceed your rental income, you can claim a loss (subject to limitations).

If you use the property as a personal residence and rent it out for fewer than 15 days per year, you don't need to report the rental income but you cannot deduct related expenses. If you itemize, you can still claim personal deductions — to the extent allowable — for mortgage interest and property taxes.

If you rent out your residence for 15 or more days per year, it's treated as a mixed-use property. You must report the rental income and allocate your expenses between the property's personal and business uses. You can claim the personal use portion as itemized deductions. The business use portion of these and other expenses are deductible as rental expenses, but they can't create a loss. Disallowed deductions may be carried forward to future years.

Family Matters

Renting property to family members means you risk losing the ability to deduct rental expenses. That's because use by family members is considered personal use, even if your relative pays rent. That is unless *both* of these requirements are met by the family member:

1. Uses the property as a principal residence, and
2. Pays fair market rent (not discounted).

If these requirements aren't met, you must report the rental income (if you rented the property for 15 days or more per year). But related expenses won't be deductible.

To avoid losing valuable tax benefits, set the rent at or above fair market value and document fair market rent with comparable local rental rates. If you give family members financial gifts to help with the rent, the IRS will likely view this as discounted rent.

Know what you're getting into.

Helping family members with housing expenses is a good thing — but be aware of the tax consequences of renting to relatives. The tax advisors at ORRPC can be a valuable resource as you make these decisions. Contact us before offering the property to family members.