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Is Your Client's Short-Term Rental Truly Tax Free?

By Michelle Freeman, Ed.D. CPA

Tennessee is well-known to tourists. According to the Tennessee Economic and Community Development blog, "millions of people from around the world choose Tennessee for their vacations" and "in 2014 domestic and international travel expenditures reached $17.7 billion." US News states the Great Smoky Mountains National Park alone brings approximately 10 million visitors annually,1 and Tennessee was rated as the #11 most popular US State to travel to in 2014 by Business Insider.2

"Tourists are drawn to Tennessee for our world-renown music, outstanding attractions and stunning scenic beauty," said Commissioner Kevin Triplett of the Tennessee Department of Tourist Development. "But, at the end of the day, people keep coming to Tennessee for our authenticity and exceptional, Southern hospitality. That is the 'made in Tennessee' brand delivered to our visitors every day by our communities and partners." 3

In addition to the many reasons to visit Tennessee listed above, there are also special events across the state on a semi-annual or annual basis. Two examples in East Tennessee are the April and August races at Bristol Motor Speedway, "the world's fastest half-mile," and the October Jonesborough Storytelling Festival. These events bring with them the opportunity for local homeowners to make some additional income by renting out their entire houses or rooms within their houses for the week or weekend. The travelers find a place to stay that is not outrageously priced with a bit of local flair and southern hospitality. The arrangement is a win/win for both.

Tax accountants have probably made these renters wellaware of the surprising loophole in the tax code which allows taxpayers to rent their personal residence for less than 15 days tax free. Tax Topic 415 states that "you don't pay tax on income you earn from the short-term rental, as long as you:

• Rent the property for no more than 14 days during the year AND

• Use the vacation house yourself 14 days or more during the year or at least 10 percent of the total days you rent it to others." 4

The peculiar exception is a popular and legal tax avoidance mechanism "sometimes called the 'Masters exception' because of its popularity in Georgia during the annual Masters golf tournament." 5 The exception can be a windfall for individuals who live near venues with annual or semiannual events or festivals that bring in masses of tourists to their area.

However, homeowners who choose to rent should beware of taxes other than federal for which they may be liable. Homeowners may not be aware that their short-term rentals are not necessarily completely tax free, and many CPAs may not be asking the questions necessary to keep their clients out of state, city and county tax liabilities and fines.

Although renting a home for less than 15 days is exempt from federal income tax, it is not necessarily exempt from state and local sales taxes, and it may also be subject to lodging (also called occupancy) taxes. Tennessee's sales and use tax laws encompass short-term lodging rentals. Tenn. Code Section 67-6-205(c)(1) states the following:

"(c) The retail sale of the following services are taxable under this chapter:

(1) The sale, rental or charges for any rooms, lodgings or accommodations furnished to persons by any hotel, inn, tourist court, tourist camp, tourist cabin, motel or any place in which rooms, lodgings or accommodations are furnished to persons for a consideration. The tax does not apply, however, to rooms, lodgings or accommodations supplied to the same person for a period of ninety (90) continuous days or more." 6

The State of Tennessee also has an Occupancy Tax, which is a "tax on any lease or rental of transient "hotels" for a period of 30 consecutive days or less to the same occupant." 7 Personal residences meet the definition of hotel. Tenn. Code Section 67-1-1401 states the following:

"hotel" is defined as any structure or space, or any portion thereof, that is occupied or intended or designed for occupancy by transients for dwelling, lodging or sleeping purposes. It includes any hotel, inn, tourist camp, tourist court, tourist cabin, motel or any place in which rooms, lodgings or accommodations are furnished to transients for consideration.

A taxpayer renting their personal residence rooms to tourists for one or two weekends per year would meet the definition of the occupancy tax because the rental is less than 30 days and the residence is covered under "any place in which rooms, lodgings or accommodations are furnished to transients for consideration."

According to an opinion issued by the Tennessee Attorney General in 2015, short-term rentals of homes, apartments and rooms arranged through websites (such as Airbnb) are subject to sales tax in Tennessee. These rentals meet the requirements of a "hotel," and therefore may be subject to the hotel occupancy privilege tax, depending on if the city or metropolitan county has adopted the tax. The property owner is responsible for collecting and paying the tax.8

A possible exception is that sales tax is not imposed on "occasional and isolated sales or transactions." This means that "individuals who rent their homes on a short-term basis infrequently or irregularly or only once are not responsible for collecting and remitting the sales tax." 8 However, "the statutes authorizing the localities to enact a hotel occupancy tax do not contain an exception for "occasional and isolated sale or transactions" similar to the exception in the sales tax. It is thus possible that an "occasional" or "isolated" shortterm rental would be subject to hotel occupancy tax, but not sales tax, unless the local ordinance enacting the tax creates an exception for "occasional and isolated" transactions or the courts imply such an exception." 8

Furthermore, not even churches or other non-profits are exempt from the hotel occupancy privilege tax. There are only two exceptions to the occupancy tax including lodging "for 30 or more days" and "local, state or governmental agencies when fees are paid by those agencies." 9

The following table displays the taxes that a homeowner in the tri-cities would be liable for based on their home rental.

Based on the above table, one can see how quickly the liability could add up.

Many homeowners are unaware that their short-term rentals are subject to these taxes. Several have never filed a sales tax return and would have no way of knowing about the municipal occupancy tax without the help of their tax preparers. As a result, tax preparers need to help their clients to be compliant with these taxes and save them from a looming tax bill. In assisting taxpayers with compliance, tax preparers need to identify the sales tax rates in their city and county as well as the occupancy tax rates, if existent, in their city and county. Taxpayers will need to file and remit sales taxes to the state and remit occupancy taxes to their respective county and/or city. 10

On a final note, if the taxpayer continues to rent space over a period of years, the IRS could deem that the homeowner is in the business of providing lodging and impose selfemployment taxes on the homeowner. "When you rent out your home, make bookings and provide amenities, like coffee or breakfast, the IRS may treat you as being selfemployed in the vacation rental business" (Intuit). Taxpayers beware. The short-term rental may not be such a windfall after all.

ABOUT THE AUTHOR

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