



DESTINATION MAUI INC.
Property Management

Tax Issues for Owners in Homeowner Type Associations

3/6/2016

Introduction

This paper deals with various income and related tax issues faced by unit owners in homeowner type associations. Due to space limitations, it is not meant to be a comprehensive discussion of these tax issues. Such a document would easily run to several hundred pages. Our hope is that you are made aware of these issues and to stimulate discussions with your professional tax preparer.

This paper addresses tax returns filed by individuals. It does not deal with corporations, S-corporations, partnerships, time-shares, limited liability companies, and non-profit organizations. The assumption is that the taxpayer is filing an individual tax return on the cash basis of accounting.

Owner Occupants

If the unit is your principal residence, you are entitled to the following tax deductions:

1. Schedule A, Form 1040 –
 - Mortgage points when the unit is first acquired.
 - Mortgage interest.
 - Mortgage insurance.
 - Real Property Taxes.

2. Sale of the unit –
 - A single owner can exclude up to \$250,000 of profit from income taxes. A married couple can exclude up to \$500,000 of profit.

 - In order to qualify for this exclusion, the owner(s) must have occupied the unit for at least 2 of the 5 years immediately preceding the sale. The 2-year requirement does not have to be continuous.

 - IRS Sec. 1031, *Tax-Deferred Exchange*, is not available on the sale of a personal residence.

Owners Who Are Not U.S. Residents

The income tax requirements for non-U.S. resident owners who rent their units differ considerably from U.S. residents.

1. Non-U.S. citizens must file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*. Married couples who jointly own the unit must file two separate 1040NR's.
2. It very important to note that a nonresident, filing Form 1040NR, must have an ITIN, *Individual Taxpayer Identification Number*. The ITIN is for tax use only. In order to obtain an ITIN, the applicant must complete Form W-7, *Application for IRS Individual Taxpayer Identification Number*, and its instruction. Form W-7 is available online at www.irs.gov. Enter "ITIN" in the search box. It takes about 7 weeks to get an ITIN.
3. For Hawaii purposes, non-U.S. citizens and non-residents of Hawaii must file Form N-15, *Individual Income Tax Return Nonresident and Part-Year Resident*. Unlike the federal form a husband and wife can file a joint return.
4. In order to take advantage of the graduated tax rates applicable to U.S. residents, the owner(s) should make the following election, "*I hereby elect to have my rental income from U.S. sources to be treated as effectively connected with a U.S. trade or business.*" This must be done on each year's tax filing.
5. Needless to say, nonresident owners should use the services of a professional tax preparer well-versed in the filing of nonresident U.S. tax returns.

Hawaii General Excise Tax

Owners who rent out their unit(s), regardless of whether it is long-term or vacation rental, resident or nonresident, have the following legal obligation to the State of Hawaii:

1. The owner is required to pay the Hawaii General Excise Tax ("GET"). The application form is BB-1 and can be made online at http://tax.hawaii.gov/forms/a1_1alphalist/.
2. The GET is currently 4%. (4.5% on Oahu) of gross revenues. The maximum GET than can be passed on to the consumer is 4.166% (not 4.17% or even 4.167%). The tax can be paid monthly, quarterly or semi-annually (Form G-45) depending on the expected annual GET. In addition, an annual GET reconciliation form (Form G-49) must be filed in order to receive a tax clearance from the State.
3. The GET is an excise tax, not a sales tax. A sales tax is imposed only the final consumer; the business is merely the entity that collects the tax on behalf of the State. On the other hand, an excise tax is imposed on the business, not the final consumer. The tax is



imposed on every level of business, e.g. from manufacturer to wholesaler to the retailer and the final consumer. There is no exemption for rentals, medical expenses or food. The only exceptions are those that are specifically exempted in the law.

4. The GET is imposed on the gross revenues collected, including any GET charged. For example, if the item charged to a consumer by the retailer (or provider of the service) is, say, \$100.00 and a GET of 4.166% is added, the business will have to pay to the Hawaii Dept. of Taxation 4% of \$104.17. Some will argue that it is a tax on a tax. Technically, that is not correct as the GET is assessed on the gross revenues of the business (that includes any GET passed on to the consumer).

Hawaii Transient Accommodations Tax (aka the “Hotel Room Tax”)

Owners who rent out their unit(s) on a vacation rental basis have the following legal obligation to the State of Hawaii:

1. Pay the Hawaii General Excise Tax as described above.
2. In addition, they must pay the Transient accommodations Tax (“TAT”). The application form is BB-1 and can be made online.
3. The TAT tax is currently 9.25% of the gross hotel revenue collected without taking into consideration the GET that may also be charged as a separate item. Unlike the Hawaii GET, only 9.25% can be charged to the guest. The tax can be paid monthly, quarterly or semi-annually (Form TA-1) depending on the expected annual TAT. In addition, an annual TAT reconciliation form (Form TA-2) must be filed in order to receive a tax clearance from the State.
4. The GET and TAT have separate filing requirements as described above. The State has a formula that must be applied in order to separate the taxes. This is necessary because the GET and TAT may be included (or not included) in the total gross revenues collected from the guest.

Long-Term and Vacation Rentals

1. Rental Agent. If the rental of your unit is managed by an outside agent, the owner will be issued a Form 1099-MISC, reporting the gross revenues earned for the calendar year. A copy of this form is also sent to the IRS and the State of Hawaii Dept. of Taxation (“DOT”).



These taxing authorities will expect that you will file the appropriate income tax returns showing this amount as the gross income received. Additionally, the DOT will check to see if you reported the gross income for GET and/or TAT purposes.

2. Income Tax Reporting. Rental income is reported on Schedule E of the individual tax return(s). Some common types of deductions are listed on the form. If you are a nonresident of Hawaii, you may be able to deduct your airfare, lodging, meals, car rental, etc. provided that the primary purpose of your trip was substantially for business purposes, i.e. attend Board and/or AOM meetings, substantial repairs or replacements to your unit, etc. If you don't meet the substantial business purpose of the trip, or part of your travel was for vacation purposes, then you must prorate your expenses accordingly.

If your unit is encumbered by a mortgage, then it is very likely that you will generate net rental losses rather than net rental income. If this is the case, then your net rental losses may be restricted:

- a. In each calendar year, if you personally use your unit for more than 10% of the available rental days or the actual rental days, whichever is greater, then you can only deduct your rental expenses up to the gross rental revenue received.
- b. If your Adjusted Gross Income ("AGI") is less than \$100,000, you can deduct up to \$25,000 of net rental losses. Any excess losses can be accumulated and carried forward until the unit is sold. At that time any unused net rental losses can be deducted.
- c. If your AGI is between \$100,000 and \$150,000, the net rental loss of \$25,000 is reduced by \$1 for every \$2 of net rental losses. This means that if your AGI is \$150,000, or more, then you cannot take any rental losses. These accumulated rental losses are carried forward until they are absorbed by some future event or when the unit is sold.

Prepared by Ronald A. Kawahara, CPA, CVA, CPM, PCAM
President, Destination Maui, Inc.
220 Imi Kala St., Suite 104
Wailuku, Maui, Hawaii 96761
(808) 244-9021
Email: rak@mauicpa.net

For more information on this and other White Papers, please visit: www.destinationmaui.net

