MAKING SELF-RENTALS WORK RIGHT

By C. Forrest Davis, EA

Mark and Nikki have a great idea for how to trim their tax bill. Except for one pesky detail: would the IRS approve?

Blue Lizard Design LLC, their graphic design studio, has prospered and now has taken over an entire wing of their home. When Nikki started the business as a sole proprietorship in a spare bedroom, she had deducted for an office in home. When the business grew and Mark joined her, they formed a multi-member limited liability company. Because the LLC is an entity separate from its owners, the firm owned no home in which to write off an office.

But what if Mark and Nikki rent the space it uses to Blue Lizard Design LLC? The company could write off the lease payments as an ordinary business expense, reducing the net self-employment income reported on the Form 1065 and their K-1s. They would have to report the rental income on their personal tax return. Net rental income is not subject to self-employment (SE) tax, however, so they would save on overall taxes.

When Nikki used Form 8829 (Expenses for Business Use of Your Home) as a sole proprietor, the deduction for business use of home was solely for the portion of actual expenses incurred for the company. With a lease, the company's write-off would be the amount agreed upon between the firm and the property's landlord (a.k.a. Mark and Nikki). The rent would not have to be for just the actual expenses—after all, landlords sometimes are in business to make a profit—so the company could have a bigger deduction.

Say the rent was for $3,000 more than the expenses and depreciation. That $3,000 profit on Schedule E would mean 15.3% SE tax savings of more than $450—right into the family's wallet.

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Watch out: Self-rental and Schedule C

Tax professionals need to scrutinize self rentals their clients claim. Nearly all self-rentals claimed on Schedule C are not allowable unless they fall under the Cox Strategy.

Rather than taking a business use of home deduction on Form 8829, an enterprising sole proprietor might envision renting property (office, vehicle, computers, etc.) to one's own business. Imagined goals might be:

- Escape from SE tax
- Avoid loss limitations for Schedule C
- Take more deduction than home office
- Reduce S corporation "reasonable salary" requirement

In addition to the other rules for business expenses, a sole proprietor (or single member LLC) has additional restrictions to take a deduction for business use of home:

- A deductible business use of home has to be regular and exclusive. A non-dwelling (commercial space) does not have to meet that restriction, only that it is an "ordinary and necessary" business expense.
- Business use of home cannot generate a Schedule C loss (beyond the mortgage interest and property taxes that could be claimed as itemized deductions).

Because of the potential traps and unique rules, tax professionals need to be familiar with self-rentals to properly guide their business clients.

Is it legal?

The basic answer is yes; self-rentals can be deductible in some settings and legally can save self-employment taxes. However, there are specific rules and limitations that parties to self-rentals must be aware of. While the tax savings can be real, the outcome is not quite everything Mark's and Nikki's creative minds could dream up.

With financially tight business environments and the increasing popularity of LLCs, self-rentals are becoming increasingly common. Income shifting could make the difference in a struggling business' survival ... until an audit. Because of the potential traps and unique rules, tax professionals need to be familiar with self-rentals to properly guide their business clients.

A "self-rental" is any situation where a business rents property from a materially participating owner of the business. Think of a self-rental as a related-party transaction and you'll realize why the IRS is picky about the process.

Perhaps the most common self-rental is the business use of an owner's home; but another common setting is where a business leases space in a commercial building owned separately by the business' owner. Many business owners have been well advised to not own retail or office real estate in their operating company, so they either own the property themselves or have set up another controlled entity to own the property.

Also, although self-rentals typically are thought of in terms of real estate, the rules apply to leasing tangible personal property (i.e., equipment and vehicles) and intangibles (intellectual property) as well, although the self-employment tax issue may not apply.

An Added Layer

To fully understand the implications of self-rentals, consider them as another layer on top of rental, business use of home, related party, passive activity loss, and other business income rules. In summary, here are some key rules that provide a backdrop for self-rentals:

- Net income earned by actively participating in a business is subject to self-employment (Social Security and Medicare) tax, creating a double whammy when added to income tax. (IRC Sec. 1402(a))
- Net income from rental real estate is treated as passive income and generally is not subject to SE tax. (IRC Sec. 1402(a)(1))
- Rental income and losses normally are passive with losses subject to the $25,000 passive activity loss limitation. (IRC Sec. 469(c)(2) and 469(i))
- Like other expenses, rent must be "ordinary and necessary" for a company to conduct business. (IRC Sec. 162(a))
- While a sole proprietor (or single-member LLC) can use Form 8829 to take a business use of home deduction [IRC Sec. 280A(c)(1)], partners or members in a multi-member LLC (MMLLC) have rigorous requirements to subtract unreimbursed partnership expenses. Business expenses normally are deducted by the company. (IRC Sec. 702(b))

Has the IRS thought of income shifting with self-rentals? Of course it has, and so have the courts. The Internal Revenue Manual (IRM 4.10.13.9) even notes: "Self-rentals are common business practice, primarily used to legitimately limit the taxpayer's liability."

Taking a look at Sec. 280A(c)(6) (Treatment of Rental to Employer), an individual cannot take the office-in-home deduction if that individual rents the property to his or her employer. This provision addresses both sole proprietors and S corporations as well as regular employees (but not partnerships, MMLLCs, or C corporations).

However, the Committee Reports to P.L. 99-514 (The Tax Reform Act of 1986) direct that independent contractors are treated as employees for the purposes of the home-office limitation, so some experts believe that partners also would fall under the rules.

Notice that these rules address the rental of space in a residential dwelling (i.e., the taxpayer's residence). The rental of a non-dwelling property (office building, retail store, shop) has slightly more liberal restrictions.

Next, examine Sec. 162(a)(3) which allows deductions for "rentals ... for purposes of the trade or business, of property to which the taxpayer has not taken ... title or in which he has no equity." In other words, a business (whether a sole proprietorship or a single member LLC disregarded entity) cannot deduct rent to itself or to its owner, who is one and the same as a Schedule C business.

Missing from that code section is how to handle rentals between a business and a landlord where an individual has ownership interests in both but is not the full owner of both. This situation could be a jointly-owned (typically husband-wife) property leased to a Schedule C business or property rented by an "entity separate from its owner" (partnership, MMLLC, C corporation).

The Self-Rental Chameleon

Then the regulations get sneaky with quintessential tax law drafting: heads, the IRS wins; tails, the taxpayer loses. Treas. Reg. Sec. 1.469-2(f)(6) "recharacterizes" self-rental income: net self-rental income is nonpassive while a net rental loss remains passive.

It may take a moment for the implications to sink in. If the self-rental generates a positive income (probably the preferred situation if avoiding SE tax), then it does not count as a "passive income generator" (PIG) to make use of suspended losses from other properties.

A taxpayer who faces the $25,000 passive activity loss (PAL) limitation will not be able to offset the self-rental income with hefty losses from other rental property. Suppose Mark and Nikki bought a rental house in 2005 which now has become a money pit. They have $40,000 of passive losses this year. They can only deduct $25,000 of those losses—as long as they are under the phaseout income limit and can actually take the full $25,000. The remaining $15,000 would fade into the future, or all $40,000 would evaporate into carryover if their income was too high.

Now, add in $10,000 of self-rental income. If it were regular rental income, that $10,000 would net against $35,000 of the $40,000 PALs and Mark and Nikki would still have a $25,000 loss with no net income (and a $5,000 carryover). However, because this $10,000 is recharacterized as nonpassive, it does not net out. The Schedule E (Supplemental Income and Loss) will show $10,000 income plus $25,000 loss. So the bottom line will be a $15,000 loss carried to the 1040 form.

Mark and Nikki have lost $10,000 of tax shelter against other income this year although the loss actually is suspended and carried over to a future year when there is passive income or the property is disposed of in a taxable transaction. It is convoluted but this result makes sense: they have been able to escape some SE tax but have not succeeded in simultaneously creating an ordinary income tax shelter. The IRS is willing to give them one tax break but not two.

Now, flip the scenario around and look at a self-rental loss. The loss is passive, so it would not offset the business net profit (unless the loss fits within the $25,000 PAL rules and the full loss carries to the front page of the 1040). In Mark and Nikki's case, a $10,000 self-rental loss would combine with their $40,000 other losses. They would still get to deduct $25,000 on Schedule E, but now the carryover is boosted to $25,000. They get no immediate benefit from the self-rental hit and the government wins again.

Structuring for Self-Rentals

The regulations read that a self-rental is an arrangement between a business and a rental property that are owned by the same person. That person has to materially participate in the business for the self-rental rules to kick in. The type of entity for the operating business is pretty much immaterial; Reg. Sec. 1.469-7(b)(1) applies the self-rental rules to passthrough entities (namely partnerships and S corporations) and Reg. Sec. 1.469-9(c)(2) applies to closely-held C corporations.

What about renting from someone who does not materially participate in the business? It has been suggested that one solution is for the business to be owned by one spouse while the rental property is owned by the other spouse who does not work in the business—the so-called "Cox Strategy."

In *Cox vs. Commissioner* (T.C. Memo 1993-326), the Tax Court ruled it was permissible for the wife to report rental of jointly-owned office space to her husband's law firm on Schedule E, although the husband could not deduct his half of the rent paid.

However, the IRS' *Audit Techniques Guide* for passive activities refers to IRC Sec. 469(h)(5), Reg. 1.469-5T(f)(3), and Reg. 1.469-1T(j), noting that material "participation of one spouse is treated as participation of the other spouse." Taxpayers who subscribe to the Cox Strategy may still encounter an auditor who challenges the spouse's rental treatment.

Another angle would be for the rental property to be owned by an entity separately from the operating business. Aside from sound asset protection, this method also bypasses the passthrough relationship and material participation spelled out in Reg. Sec. 1.469-2(f)(6).

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Make It Work: Self-Rental Checklist

- ☐ Have a business, rather than a tax, reason for doing the arrangement. Meet the "ordinary and necessary business expense" test and the "economic substance" doctrine.
- ☐ Sign a written lease agreement between the operating company and the property owner, so it is an "arm's-length transaction."
- ☐ Set the rent at a fair market value based on local real estate market reports. (Check with local commercial real estate brokers for going market rates; many post reports on their websites.)
- ☐ Make the rent payments regularly and faithfully, just as if they were to an unrelated landlord. Also, make the rent payments by check, not as an accounting adjustment.
- ☐ Consider owning the rented property separately from the owner who works in the business. It might be owned by an entity such as an LLC, by a spouse, or through some other arrangement that would avoid the material participation rules.
- ☐ Look into the local sales tax, property tax, and zoning requirements before jumping into a business rental in a residential property.

This additional layer of separation avoids the "holding title" restrictions of Sec. 162(a)(3). In the author's opinion, this tactic would not satisfy the IRS for a Schedule C filer but might fly for a partner.

IRC Sec. 707(a)(1) stipulates: "If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall ... be considered as occurring between the partnership and one who is not a partner." Consequently, rental of personally-owned property to a partnership-type entity appears to fall under this rule, although the presence of another entity (an LLC, for example) which owns the property might make the distinction clearer.

Think "arm's-length transaction" and "economic substance doctrine" to help assess whether such a rental will pass audit review. However, this approach has not been adequately tested in the courts and some court decisions suggest that the controlled group rules intended for corporations might be applied here.

The IRS requires that the rent be at fair market value (FMV), so self-rental taxpayers should be prepared to justify their rental rate is in line with going local rents. Both undercharging or overcharging rental rates can incur IRS wrath. Rental payments that are excessive compared to the market can be reclassified to business income (Maschmeyer's Nursery, Inc., TC Memo 1996-78) while an auditor might impose constructive receipt of rental income for payments that are too low. Owners often can find current local figures from commercial real estate brokers, management companies, economic development agencies, multiple listing services, academic research centers, and news reports.

An important consideration in owning the real estate separately from the operating business is the event of a sale. If the business is sold but the real estate is kept by the seller and then leased to the non-related buyer, the self-rental rules take effect because of the seller's past material participation (Treas. Reg. Sec. 1.469-5(j)(1)).

On the other side, selling the real estate outside the operating company can protect the company from capital gains tax hits that could disrupt its financial statements and tax situation.

More Ways to Play

Self-rental is not the only game in town, and tax preparers should help their clients consider whether one of these alternatives might better suit their situation before deciding to create a self-rental:

1. Sale-leaseback. The sale and subsequent leasing of the previously-owned property has long been a popular strategy for commercial real estate. The beleaguered state of Arizona recently sold its state capitol under a sale-leaseback arrangement. From a business standpoint, a sale-leaseback moves an asset off the balance sheet and onto the income statement as an expense, generates cash from the sale, hedges against future declines in market value, and boosts financial ratios, which in turn can make the company's stock look more attractive and borrowing easier.

However, Sec. 469(f)(1) (Treatment of Former Passive Activities) can prevent the deduction of losses on the sale, particularly if the lease is for thirty years or more. Also, the IRS may deny the sale if the seller has rights to repurchase the property.

2. Vacation home rules. Income received for renting a personal dwelling for less than fifteen days a year is not reportable (and, correspondingly, the expenses are not deductible). The rent paid, of course, is deductible by the payer if it is for business use. Some individuals may be able to skate around the self-rental restrictions by taking advantage of the vacation home rules, renting the home for only a few days a year for meetings or other events. If this sounds legally shaky, consider that Hollywood movie studios routinely schedule shoots at rented homes so they are on location no more than two weeks, and then pay the displaced owner perhaps several thousand dollars a day—all legitimately tax-free.

3. Accountable plan reimbursements. An accountable plan reimbursement works similar to the vacation home rules: the payment is deductible as a business expense to the payer while as a reimbursement for actual expenses incurred it is not taxable to the recipient. The catch is that the payment has to be for the amount of actual property expenses and no more, so the SE tax avoidance is lessened. However, some taxpayers may find avoiding income appearing on Form 1040 advantageous, particularly if their AGI triggers phaseouts of itemized deductions or other tax benefits.

The Local Element

Tax advisors should alert clients who are considering self-rentals to local tax implications that may not be obvious. Many cities and states collect sales tax on commercial rentals. That would be expected if someone rents a store building to his retail business, but could be a financial and paperwork factor when renting office space in a residence to his consulting company.

A conscientious taxpayer who files and pays sales tax on his business rental may discover the space is reassessed from residential to commercial at a higher property tax rate. That in turn could create planning and zoning considerations and even a visit from the fire marshal (although many cities offer a simple home business permit process).

Unstacking the Deck

Does having the deck stacked in favor of the IRS mean self-rentals are not worth the trouble? In this author's opinion, the answer is no.

Self-rentals can be effective tax planning tools to shift income away from self-employment tax. They are common among middle-tier entrepreneurs who often own real estate as an investment as well as own operating businesses and use them together.

Taxpayers normally are not aware of the complexities of self-rentals that can undermine their goals. The assistance of a knowledgeable tax advisor in structuring a self-rental can translate into dollars in the client's pocket plus peace of mind. **EA**

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References and Resources

CODE SECTIONS AND REGULATIONS

Sec. 162 Trade or business expense

Sec. 262 Personal, living, and family expenses

Sec. 267 Losses, expenses, and interest with respect to transactions between related taxpayers

Sec. 280A Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

Sec. 469 Passive activity losses and credits limited

Sec. 707 Transactions between partner and partnership

Sec. 1402(a) Net earnings from self-employment

Treas. Reg. Sec. 1.469-2(f)(6) Property rented to a nonpassive activity

Temp. Treas. Reg. 1.469-2T Passive activity loss

Treas. Reg. Sec. 1.469-5 Material participation

IRS PROCEDURES

The IRS has addressed self-rentals in several sections of its *Passive Activity Loss Audit Techniques Guide* available at
www.irs.gov/pub/irs-mssp/pal.pdf and at www.irs.gov/businesses/small/article/0,,id=146318,00.html

Legal citations and court cases: See the extensive listing at
www.irs.gov/businesses/small/article/0,,id=146818,00.html

Internal Revenue Manual IRM 4.10.13.9 (03-30-2005)
Self-Rented Property:
www.irs.gov/irm/part4/irm_04-010-013-cont01.html#d0e3396

TAXPAYER INFORMATION AND FORMS

Pub. 925 (Passive Activity and At-Risk Rules)
www.irs.gov/pub/irs-pdf/p925.pdf

Form 8582 (Passive Activity Loss Limitations Instructions)
www.irs.gov/pub/irs-pdf/i8582.pdf

Pub. 527 (Residential Rental Property)
www.irs.gov/pub/irs-pdf/p527.pdf