



Self-Rental Rule

Don't get caught in a trap of unintended consequences.

by Daniel Rowe, CPA

The only thing worse than incurring a loss on investment property is incurring a loss that cannot be deducted for tax purposes. Self-rental property may cause this tax result for some property owners if rental arrangements are not strategically prepared. The following overview of the self-rental rule, including an explanation of passive activities in the context of rental real estate, may shed light for property owners who want to avoid such tax consequences.

Passive Activities Concept

The Internal Revenue Service considers most business activities to be nonpassive if a taxpayer materially participates in the business. One exception to this rule is rental real estate.

Partly because of their past use in tax shelters, rental real estate activities are generally considered passive regardless of participation level. (There are exceptions that go beyond the scope of this article.) The distinction between passive and nonpassive activities is important

because under the passive activity loss rules, a passive loss usually can only be used to offset passive income. Generally, any passive loss that exceeds passive income is suspended and carried forward to be deducted in a future year. However, there is an exception of up to \$25,000 for taxpayers who actively participate in a rental real estate activity. Nonpassive loss, on the other hand, can offset both passive and nonpassive income.

Self-Rental Nuances

Taxpayers can generally offset rental income from one property by rental loss from another property, as passive loss is

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Potential tax consequences of a self-rental arrangement can make a bad situation even worse.

deductible to the extent of passive income. However, an exception to this simple rule occurs when property is rented to one's self or a business in which one materially participates. In such a case, the rental real estate activity's treatment as passive or nonpassive varies depending on whether it produces income or loss.

For example, assume Juan has three activities for tax purposes: He is the sole owner of a bookstore, in which he materially participates, and he owns two rental properties—a warehouse and an apartment building—that are passive by nature. The activities generate \$150,000 income and \$100,000 loss, with a net gain of \$50,000. (See Example 1.) The rental loss can offset rental income, with the excess loss then suspended. The result for Juan is \$100,000 of taxable income and \$50,000 of suspended loss.

But suppose Juan rents the warehouse to his bookstore instead of an unrelated third party. This is when the self-rental rules come into play to recharacterize the rental activity.

In the case of a self-rental, income is treated as nonpassive and loss is treated as passive. Thus, the warehouse income is nonpassive and the apartment loss cannot be deducted against it. Because of the self-rental trap, Juan's tax result is \$150,000 of income and \$100,000 of suspended loss, as shown in Example 2.

Because he is renting to himself, Juan controls the rent that the bookstore pays. By adjusting this amount he can theoretically create a loss for the bookstore. If he increases the bookstore's rent for the warehouse by \$125,000, he will get the results in Example 3, which is \$150,000 in taxable income and \$100,000 in suspended losses. Again, because it is a self-rental, the warehouse income is treated as nonpassive.

The result would be the same even if Juan's spouse was running the bookstore business. In determining material participation, participation by Juan's spouse is considered participation by him as well. The self-rental

rule's primary purpose is to prevent taxpayers from manipulating rent for companies they (or their spouses) own and operate to create passive income to use against other passive losses.

Avoiding the Trap

Taxpayers can avoid or reduce the detrimental tax effect of the self-rental rule. One way is to reduce their participation level in the operating activity so it fails the material participation tests. Then both the operating activity and the rental activity will be considered passive and the self-rental rule will not apply. However, it is usually not feasible for owners to reduce their participation, especially when the operating activity is their primary business. The interplay of the operating activity and its income or loss with any other activities of the taxpayer should be analyzed in aggregate prior to considering a reduction in participation.

A more reasonable method of combating the self-rental rule is to minimize net income for the rental activity. A net loss will still be

subject to the normal PAL rules, so minimizing loss may be important as well. However, fair-market rent must be charged, as an artificially high or low rent used to manipulate income will not withstand IRS scrutiny.

Another option is to rent from a third party. To avoid the poor tax results in Example 2, Juan's bookstore could rent a warehouse from an unrelated party and he could rent his warehouse to another unrelated company for an offsetting amount. This method relies heavily on market conditions that allow Juan to find both a tenant for his property and his own lease space.

It's not always easy or practical to avoid the reclassification of income under the self-rental rule. Property owners or investors who rent to themselves or their entities should be aware of the potential tax consequences that can make a bad situation even worse.

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Effects on Taxable Income

	EXAMPLE 1	EXAMPLE 2	EXAMPLE 3
Nonpassive	Bookstore \$100,000 income	Bookstore \$100,000 income Warehouse \$50,000 income	Bookstore (\$25,000) loss Warehouse \$175,000 income
Passive	Warehouse \$50,000 income Apartment (\$100,000) loss	Apartment (\$100,000) loss	Apartment (\$100,000) loss
Net	(\$50,000)	\$150,000 income	\$150,000 income
Taxable income	\$100,000	\$150,000	\$150,000