How to Handle Self-Rented Property

By Wendy D. Shireman, CPA

If you're a CPA in public accounting, there's a good chance you have individual clients with rental properties. There is also a good chance some of these clients are renting that property to a company in which they have ownership in, or materially participate in the operations. Because any transactions between related parties are subject to close IRS scrutiny, special care must be used when dealing with these arrangements.

One issue to make clients aware of is to ensure they have lease agreements that are supported by written contracts. Another important point is the amount of rent being charged. The annual rent must be reasonable, and if possible, supported by evidence such as comparable leases in the area. Another place where this relationship can become further complicated is when property owned by an individual is rented to any entity in which that individual materially participates. When that is the case, the income from the rental activity is subject to the recharacterization rule of Reg. 1.469-2(f)(6), unless the contract was executed before Feb. 19, 1988. This rule states that if a taxpayer derives rental income from a property that is rented to an entity the taxpayer materially participates in, that income is characterized as nonpassive. However, if the property has a loss from the rental activity, then that loss is characterized as passive. To add to the challenge, this is a rule that many tax preparation software may not handle properly, and could require input changes to the codes year after year. And, because it is something that goes against the general classification of all rental income as passive regardless of participation, there is a chance that some practitioners are missing this issue.

So, when does the rule apply? First, there has to be material participation on behalf of the taxpayer in the entity that is the tenant of the property. This is satisfied if the taxpayer can answer "yes" to any one of the following seven questions:

1. Did the taxpayer participate more than 500 hours for the year in the day-to-day operations of the activity?
2. Did the taxpayer do substantially all the work in the activity compared to other individuals participating in the activity?
3. Did the taxpayer participate more than 100 hours and more than any other individual?
4. Did the taxpayer participate more than 100 hours but not more than 500 hours in two or more activities, so that the total participation is more than 500 hours?
5. Did the taxpayer materially participate in this activity for any five of the last 10 years?
6. If the activity is a personal service activity, did the taxpayer materially participate for any of the three preceding tax years?
7. Did the taxpayer have any other facts or circumstances that indicate material participation?

It is important to note that if the taxpayer's spouse meets any of the above tests, the taxpayer is considered to materially participate, even if they do not file a joint return and the spouse does not have any ownership in the activities. The entity type of the material participation activity is irrelevant. The recharacterization applies to property rented to corporations, partnership, and limited liability companies alike.

If a taxpayer actively participates in the self-rental activity during the tax year, is married filing a joint return, and has adjusted gross income less than $100,000, they qualify for a $25,000 loss allowance from the passive rental. Active participation standards are much less stringent than the material participation standards discussed above. Other than the above exception, passive losses are generally only allowed to the extent there is passive income. Therefore, it is possible for a taxpayer to have losses from self-rented property for several years that are not allowed as a deduction on the return, accumulating suspended passive losses to be carried forward. Then, in a subsequent tax year, the taxpayer may have income from the property. In this situation, there is a positive element in the recharacterization Regulation 1.469-2(f)(6). It says in a year in which the activity has net rental income, the prior year suspended passive losses can be used to offset the current year nonpassive income from that same property. However, the taxpayer is not permitted to offset income from other activities. When dealing with any arrangements between related parties it is wise to assume there will be special exceptions in the law.

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