Self-Rental Rule

Abstract:
The IRS regulation on self-rental provides that when a taxpayer rents property to his or her own business, the rental profit is not treated as passive activity income. This means it can not be used to offset passive activity losses. This material has examples illustrating the concept of the regulation and lists recent court cases affirming the regulation.

TOPIC 2: THE SELF-RENTAL RULE UNDER TREAS. REG. §1.469-2(f)(6)

General Information

The self-rental regulation poses a considerable risk to preparers who ignore it when completing Form 8582, Passive Activity Loss Limitations. In an IRS exam, the examiner probably will raise the issue and propose adjustments to claimed passive losses. **All five court cases, shown in the Conclusion of this section, have been decided in favor of the IRS.** The issue in the court cases is whether the regulation is valid. The courts have consistently ruled that it is.

In the IRS's Market Segment Specialization Program (MSSP) guidance to IRS examiners for Passive Activity Losses, the self-rental rule is emphasized. IRS examiners are encouraged by the MSSP to raise the self-rental issue when conducting exams involving reported passive activity losses.

This issue is most likely to occur when professionals such as dentists or attorneys incorporate and lease personally owned buildings to their corporations. In four of the five court cases, the taxpayers involved were dentists or attorneys.

Treas. Reg. §1.469-2(f)(6) (The Self-Rental Rule)

The regulation states: An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as **not from a passive activity** if the property:

a. Is rented for use in a trade or business activity in which the taxpayer **materially participates** for the taxable year, and

  a. Is not described in I.R.C. §1.469-2T(f)(5).
  b.

In essence, this regulation provides that when a taxpayer rents property to his or her own business, the rental profit is not treated as passive activity income.

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Practitioner Note. The following example uses facts similar to the *Krukowski* Tax Court case discussed on
pages 653–654 of the *2000 Farm Income Tax School Workbook.* [*Krukowski v. Commissioner,* 114 T.C. 366 (2000).

Example 1. Tom Kaye is the president and sole shareholder of two C corporations. One operates a health club and the other is Tom's law firm. He owns and rents a building to each corporation. On the joint 2001 return for Tom and his wife, Susan, Schedule E (Form 1040) shows the following:

Property	**Rents Rec'd**	**Expenses**	**Rental Profit (Loss)**
Health club building	$ 36,000	$105,000	$ (69,000)—Loss
Law firm building	$300,000	$125,000	$175,000—Profit
Net rental income on the 2001 Schedule E			**$ 106,000—Profit**

For passive activity loss purposes, Tom **materially participated** in the activities of his law firm as an employee/shareholder. However, he did **not** meet the material participation test for his health club.

Question 1. If the preparer **ignores** the self-rental regulation, what will be the tax result for 2001 for Tom and his wife?

Answer 1. The two rental activities will be treated as passive activities and will be entered on Tom and Susan's Form 8582 as shown. The tax result is that the $69,000 rental loss on the health club building will be allowed to partially offset the $175,000 rental profit on the law firm building. Thus, the $106,000 net rental income figure shown on the 2001 Schedule E will be reported on line 17 of Form 1040.

Question 2. If the preparer follows the self-rental regulation, what will be the tax result?

Answer 2. The $69,000 rental loss on the health club building will be treated as a **passive** activity and will be entered on Tom and Susan's Form 8582 as shown. However, the $175,000 rental profit on the law firm building is considered **nonpassive** income and is omitted from Form 8582.

The tax result is that the $69,000 rental loss on the health club building is a **suspended** passive loss for 2001. It is **not** deductible on their 2001 Form 1040. Tom and Susan have no other passive activity income in 2001 to absorb and allow the deduction of the $69,000 rental loss.

Conclusion

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There is no adequate authority for preparers to ignore the self-rental regulation. However, if it is ignored, preparers must attach Form 8275-R, Regulation Disclosure Statement, to protect the client from potential exam penalties.

Listing of Court Cases That Hold the Self-Rental Regulation To Be Valid.

1. ***Krukowski v. Commissioner,*** 114 T.C. 366 (2000) (see pp. 653-654 of the *2000 Farm Income Tax School Workbook*)

2. ***Sidell v. Commissioner,*** 225 F. 3d 103 (1st Cir. 2000)

3. ***Fransen v. United States,*** 191 F. 3d 599 (5th Cir. 1999)

4. ***Connor v. Commissioner,*** 218 F. 3d 733 (7th Cir. 2000)

5. ***Schwalbach v. Commissioner,*** 111 T.C. 215 (1998)

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