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## Don't shoot yourself in the foot

# Beware of the self-rental rule

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Do you rent property to one of your business entities? It may seem like an innocent action, but that "self-rental" arrangement could have significant — and potentially negative — tax repercussions.

**The passive activity loss rules**

To understand the tax repercussions of self-rental arrangements, you first must understand the passive activity loss rules. A passive activity loss is the excess of the taxpayer's aggregate losses from all passive activities for the year over the aggregate income from all of those activities.

The Internal Revenue Code (IRC) generally prohibits taxpayers from deducting passive activity losses against other income, such as salaries, interest, dividends and income from nonpassive business activities. Typically, a passive activity loss can be used to offset only passive income. (The IRC does provide a few exceptions; contact your CPA for more information.)

So, what distinguishes a passive activity from a nonpassive activity? The IRC defines "passive activity" as any trade or business in which the taxpayer doesn't materially participate. A taxpayer "materially participates" in a business if he or she works on a regular, continuous and substantial basis in operations.

Rental real estate activities generally are deemed passive regardless of whether the taxpayer materially participates. However, some exceptions do apply; one is the self-rental rule.

Under the self-rental rule, if a taxpayer rents a property to a business in which he or she materially participates, any net rental *income* from the property is deemed to be *non*passive. Net rental *losses* on such property, however, generally remain *passive*.

**The potential problems**

Suppose, for example, that you own two rental properties — an apartment building and a warehouse. You rent the warehouse to a business in which you materially participate as owner and president. At the end of the tax year, you've suffered a loss of $100,000 on the apartment building, while the warehouse has a net income of $100,000.

You might initially think that you can just offset the income from the warehouse with the loss on the apartment building. But you would be wrong.

Because you essentially rented the warehouse to yourself, the self-rental rule applies and the income is treated as nonpassive. Therefore, it can’t be offset with the passive loss from the apartment building. Yet, if you had incurred a net loss on the warehouse rental, it might be treated as an additional passive loss that couldn’t be currently deducted unless you had other passive income. (However, note that, if the business and real estate have the same ownership, it may be possible to group the two activities together as one nonpassive activity.)

Or consider this situation: You sell a business you’ve owned for a decade, but you hold on to the real estate associated with it so you can rent it to the buyer of the business. You’ll receive net rental income from the lease arrangement, which you plan to offset with other passive losses in the years after the sale.

Unfortunately, under the material participation rules, you’re deemed to have materially participated in an activity (or business) if you materially participated in it for five out of the previous 10 years. As a result, for tax purposes you’re still materially participating in the business you sold and, thus, under the self-rental rule, the rental income will be nonpassive — and you won’t be able to offset it with the other passive losses for at least five years.

## Plan ahead

If you’re not careful, a self-rental arrangement can come back to haunt you. Make sure you work with your CPA in such situations. He or she can help you protect yourself.