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Internal Revenue Manual 4.10.13.9 (03-16-2015)

Self-Rented Property and Renewable Options

1. Self-rental income is rental income of a taxpayer from property leased to a trade or business activity in which the taxpayer materially participates. See CFR 1.469-2(f)(6). Self-rentals are a common business practice, primarily used to limit the taxpayer's non-tax liability with respect to the rental property.
2. While rental income is generally passive income, which can offset unrelated passive losses, certain types of rental income are recharacterized as nonpassive income, the most common being self-rental income. If a taxpayer leases property to a business in which he materially participates within the meaning of temp CFR 1.469-5T, net rental income is treated as nonpassive income under this rule. Self-rental income is reportable on Schedule E. It should not be entered on the individual taxpayer's Form 8582, Passive Loss Limitations, where it could otherwise be used to offset passive losses from other activities. However, a net loss from a self-rental activity remains passive and should be reported on the Form 8582.
3. There is an exception to the recharacterization of self-rental income. CFR 1.469-11(c)(ii) permits self-rental income to be treated as passive income if there is a written binding lease entered into before February 19, 1988. As a practical matter, the Service seldom sees leases signed prior to 1988 that bind current years. Thus, self-rental income is generally recharacterized as nonpassive income and cannot be entered on Form 8582.
4. The question often arises whether a new lease, signed after 1988 under a renewable option provision in a pre-1988 contract qualifies for the written binding lease exception described in paragraph (3), above. A new lease as a result of an option to renew provision does not meet the exception in 26 CFR 1.469-11(c)(ii). The clear language of 26 CFR 1.469-2(f)(6) and 26 CFR 1.469-11(c)(ii) provides that the grandfather exception, which permits self-rental income to be treated as passive income, applies only to rental obligations in existence before February 19, 1988. State law generally draws a distinction between options and the underlying enforceable obligation. While an option may exist, generally there is no underlying enforceable legal obligation until the option is exercised, which clearly is post-1988 for most renewable options in current years. Thus, rental income based on a renewable option is nonpassive income. This income should not be entered on Form 8582 as passive income, which would allow unrelated passive losses to become deductible.

Note: See Krukowski, 114 T.C. 25 (05/22/2000) for an example of a case in which the Court held that the renewable option did not constitute a pre-1988 binding contract.