

## Internal Revenue Manual 4.10.13.9 (03-30-2005)

### Self-Rented Property and Renewable Options.

1. Self-rental income is income from property leased by an individual taxpayer to a business where he works. Self-rentals are common business practice, primarily used to legitimately limit the taxpayer's liability.
2. While rental income is generally passive income, which can offset unrelated passive losses, certain types of rental income are recharacterized as nonpassive, the most common being self-rental income. If a taxpayer leases property to a business where he works, net rental income is treated as nonpassive under Treas. Reg. 1.469-2(f)(6). Stated differently, if a taxpayer materially participates in a business and that activity leases his real or personal property, income from the leasing activity is nonpassive. While the income is reportable on Schedule E, it should not be entered on the individual taxpayer's Form 8582, Passive Loss Limitations, where it will trigger otherwise nondeductible passive losses.
3. There is an exception to the recharacterization of self-rental income. Treas. Reg. 1.469-11(c)(ii) permits the rental income to be used 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, which bind current years. Thus, self-rental income is generally nonpassive and cannot be entered on Form 8582. However, 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.
4. A new lease as a result of an option to renew provision does not meet the exception in Treas. Reg. 1.469-11(c)(ii). The clear language of 1.469-2(f)(6) and 1.469-11(c)(ii) provides that the grandfather exception, which permits self-rented income to be treated as passive, applies only to rental obligations in existence before 02/19/1988. 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. It cannot be entered on Form 8582 as passive income, which triggers deductibility of unrelated passive losses.

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.