



April 2017

## Tax-Free Income from Rental of Home to C or S Corporation

### Question

My CPA tells me that IRC Section 280A allows me to rent my entire home to my S corporation for 14 days or less during the year and get big tax deductions.

In the example, he explained that I could charge my S corporation \$1,500 for each day of use. This rate equals what I would have to pay to rent a home that's pretty much like mine. Say I rent the home for 14 days. That gives the S corporation a \$21,000 tax deduction for the year.

He next explained that on the personal side of the ledger I don't get any tax deductions for the rental of the house, and I also don't include the rental income on my personal tax return.

Because I operate as an S corporation, this strategy creates a net \$21,000 tax deduction when passed through to me.

This seems almost too good to be true.

What is your opinion? Do you have any articles that cover this subject?

### Answer

In general, yes, this strategy works: the IRS has said so in a private letter ruling.<sup>1</sup>

As to our having existing articles on this topic, read [Learn a Simple Strategy for 100 Percent Tax-Free Rental Income](#), where we discuss in depth this little-known escape from taxes.

We don't specifically discuss renting from your own S corporation in that article, so we'll discuss it here.

### Minefields



Having your S corporation rent your home from you for 14 days or less during the year brings up the following seven tax issues:

1. Will the tax law prohibition on deductions for the employee renting to the employer destroy the strategy?<sup>2</sup>
2. Could the entertainment facility rules disallow the entire strategy?<sup>3</sup>
3. Wouldn't renting to your corporation simply create personal use under the vacation-home rules and thus eliminate the benefits?<sup>4</sup>
4. Would the rule that disallows a tax deduction to a related party when the other related party does not have income from the transaction deny the benefit?<sup>5</sup>
5. Will the "no deduction for personal, family, or living expenses" rule eliminate the deduction?<sup>6</sup>
6. Can the rental pass the ordinary and necessary business expense test?<sup>7</sup>
7. Could the IRS recast this rental as a sham using the substance-over-form doctrine?<sup>8</sup>

Now, let's see how you overcome each of the seven obstacles that could surface in your S corporation's rental of your personal home.

## ***1. Disallowed Deductions on Employee Rental to Employer***

You are an employer-owner of your S corporation. Section 280A(c)(6) disallows rental deductions to the employee who rents his or her home to the employer. This is you, as you are an employee of your corporation, and you are renting to your employer.

**No problem.** This section causes you no trouble because under the 14-day free-rent rule, the tax code does not allow you, the homeowner, to claim any tax deductions. (Thus, you claim no deductions for the home under the 14-day rule and therefore there is nothing to disallow on your personal tax return. And frankly, you don't care about those deductions anyway—you are looking for the corporate deduction and your receipt of tax-free rental income.)

Here's a second nail that you can hammer into the employee-deduction-disallowance section of the law: the tax-free-rent section of the tax law overrides the employee-deduction-disallowance section.<sup>9</sup>

So far, so good. You're one for one in overcoming the seven potential obstacles.

## ***2. No Deductions for Entertainment Facilities***

Trouble! Yes. Be alert.

Don't have the S corporation rent your home to entertain patients, prospects, or customers. In general, the entertainment facility rules disallow deductions for a facility used for entertainment, and that disallowance would defeat your rental strategy. So don't rent the home to your corporation for any entertainment use.

There's one exception: for the annual employee holiday party or summer picnic, the disallowance of entertainment facilities rules don't apply.<sup>10</sup> Further, that ugly 50 percent cut that applies to entertainment (including facilities) does not apply to the employee holiday party or summer picnic.<sup>11</sup>

With these rules in mind, limit the rental of your home to your S or C corporation to business meetings, staff retreats, and employee events exempt from the entertainment facility rules.

By overcoming the entertainment facility problem, you're two for two in eliminating the obstacles in the minefield.

## ***3. Rental to Related Party (Part 1)***

You have no problem with the related-party rules.

First, for purposes of the related-party rules that apply to the 14-days-or-less rental arrangement, you and your family members are related, and the law deems that this family group has an interest in the rental, but your corporation is not included in the group.<sup>12</sup>

Thus, you have no Section 280A related-party problem renting to your corporation.

## ***4. Rental to Related Party (Part 2)***

Second, you have no problem with the related-party rule that allows no tax deduction when the recipient related party does not have to include the income. Why? This rule applies only "by reason of the method of accounting," and that's not applicable here.<sup>13</sup>

In this rent-to-your-corporation strategy, your methods of accounting either are the same (such as the cash method) or, even if different, are not the reason you exclude the income from taxation. The law allows the nonrecognition of income.

You are moving right along. You have disposed of the first four of seven possible impediments to your rental strategy.

## **5. Disallowed Personal, Family, or Living Expenses**

Tax law has long recognized use of the personal home for more than one purpose, such as using part of the home for an office or renting part of the home to a third party.<sup>14</sup>

If you clearly show the expense for the rent paid and the business activity that took place, you have no trouble with the personal, family, and living-expense rules.

You continue your perfect score. You're now five for five on surmounting the obstacles to renting your home tax-free.

## **6. Ordinary and Necessary Business Expense**

The rental of space for business meetings and the annual employee holiday party is without question an ordinary and necessary business expense. Thus, you have a straightforward business purpose for the S corporation's rent payment.

In *Roy*, the court noted that the tax-free rule itself contains no requirement that you rent the home at fair rental value for it to be tax-free under the 14-days-or-less rule.<sup>15</sup>

But the IRS privately ruled that the S corporation's deduction for a rental payment to one of its shareholders can't exceed the residence's fair rental value for the activity.<sup>16</sup>

Thus, despite *Roy*, you should pay a fair rental value (but no more!) and document that the rent is fair. Further, spend a few moments documenting that the business activity took place. Consider taking photos and having them processed so that the date of processing shows on the prints.

That's six out of seven obstacles removed.

## **7. Substance over Form**

We don't see any problem for you on this front if the rent paid is a fair rent and the business activities take place.

Your ability to exclude the rent from taxation comes from the law itself, so there's no argument here. Your corporation's ability to deduct the rent it pays for a business meeting and holiday party space is certainly not a substance-over-form issue.

And now you've passed all seven obstacles to renting your home tax-free to your S or C corporation.

## Takeaways

If you operate your business as a corporation, the strategy of renting your home to the corporation for 14 days or less produces a near-perfect tax deduction.

In this article, you see how this CPA is on target with his recommendation.

- His client's S corporation realizes a \$21,000 rental deduction.
- The rental deduction reduces the S corporation's income, and that reduced income passes through to the S corporation owner.
- The S corporation owner reports the S corporation income (after reduction at the S corporation level for the rent) on his personal Form 1040.
- Because the homeowner rented his home for 14 days or less, he has no taxable income.

To make sure you don't have trouble:

- Avoid the entertainment facility problems.
- Pay and document a fair rent.
- Document that the business activity took place.

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1 FLR 8104117.

2 IRC Section 280A(c)(6).

- 3 IRC Section 274(a)(1)(B).
  - 4 IRC Section 280A(d)(2).
  - 5 IRC Section 267(a)(2).
  - 6 IRC Section 262.
  - 7 IRC Section 162.
  - 8 Gregory v Helvering, 293 U.S. 465 (1935); Frank Lyon Co. v United States, 435 U.S. 561, 573 (1978).
  - 9 IRC Section 280A(g).
  - 10 IRC Section 274(e)(4).
  - 11 IRC Section 274(n)(2)(A).
  - 12 IRC Section 280A(d)(2)(A).
  - 13 IRC Section 267(a)(2)(A).
  - 14 IRC Section 280A; Rev. Rul. 76-287.
  - 15 Leslie A. Roy v Commr., TC Memo 1998-125.
  - 16 PLR 8104117.
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