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The importance of fair market rent when renting an investment property to a family member - by Lynne Bagby

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Sometimes New England investment property owners rent property to a family member or would like to purchase an investment property in a 1031 exchange transaction to rent to a family member. In some situations, these investors have collected either very little or no rent because they were providing a break to a family member. It is important for real estate investors to realize that the IRS has issued guidance on the subject of “fair market rent” when renting to a family member and they should discuss this with a knowledgeable tax advisor.

A 2013 Tax Court decision, *Adams v. Commissioner*, T.C. Memo 2013-7, demonstrates the importance of taxpayer real estate investor receiving fair market rent when desiring to obtain the tax deferral benefits of a 1031 exchange. In *Adams*, the investor exchanged into a replacement property that was rented to the investor’s son and family. The IRS challenged this exchange and claimed the property was considered a “family home” since the actual rent paid from the son to his father was considered below market rent.

However, in *Adams*, the replacement property was in poor condition at the time of the investor’s exchange. The investor’s son had experience as a contractor and personally made extensive repairs to the property, and the son paid for the materials needed to perform the repairs. In addition, the investor’s son lived in the property for the next four years and continued to maintain and repair the property, picking up the costs of these repairs out-of-pocket. The Tax Court determined that the rent received from the son, plus the value of the improvements made by the son, constituted fair market rent. Consequently, the Court ruled there was no bargain rent. This case highlights the importance of receiving fair market rent when renting a property to a family member.

For example, Revenue Procedure 2008-16 addresses a safe harbor for vacation homes investment and whether or not a dwelling unit qualifies as property held for productive use in a trade or business or for investment under Section 1031 of the Internal Revenue Code. In Revenue Procedure 2008-16, it is noted that the dwelling unit must be rented “at a fair rental.” Later in this Revenue Procedure, in Section 4, Fair Rental is specifically defined, “For the purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all the

facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taking into account.” The definition in this Revenue Procedure indicates that the IRS will look at all the facts and circumstances of a particular exchange to ascertain whether or not fair market rent was received.

Some planning considerations when renting to a family member are: 1) rent at a price that is comparable to other similar rental properties in the market; and 2) the taxpayer should enter into a rental lease agreement in the same manner they would with any tenant of an investment property. If a longer term rental, make sure the relationship is solely that of a landlord and tenant, the rent received is appropriate to the local market, and the terms of the rental agreement strictly construe the rights and responsibilities of the parties as a landlord and tenant.

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