

Deducting rent paid to a related party

In general, of course, rent paid on business or investment property is deductible. In fact, the tax code doesn't even specifically state that the rent must be "reasonable," as it does for other deductions. However, transactions between "related parties" typically come under close scrutiny by IRS. And if rent paid to a related party is found to be "unreasonable," the deduction will be reduced. In many such cases, the rent found to be excessive is recharacterized as a distribution of profits, or a gift, as the case may be. You will be in a better position to show that the rent paid in your transaction is reasonable if you take specific steps at the inception of the rental arrangement to support it.

Establishing fair rental value. A recommended way to establish that the rent in your transaction is reasonable is to show that it's in line with rent paid by unrelated parties for property that is comparable to yours. Accordingly, you should contact independent realtors or brokers to get appraisals based on comparable properties. The more, the better.

If the fair rental values you get in this fashion are below the amount you seek to set for your transaction, carefully document why your particular property should be valued higher. This may be the case for any number of reasons: improvements made to the property, special features or location, etc.

Rent is often viewed as a combination of a property's value with a reasonable rate of return. You may be able to justify setting a higher rent by showing that rates of return for your particular industry or investments run higher than elsewhere.

Percentage rentals. Taxpayers sometimes seek to set rent as a percentage of profits. This is a perfectly acceptable technique and can be used to protect against inflation or other risk factors. Where this approach is taken, however, there is a greater possibility that rents will reach unusually high levels, i.e., in particularly high income years. To protect against a potential IRS disallowance in such years, it's important to show that the percentage rental arrangement was reasonable *when it was established*. Accordingly, advance planning is even more strongly advised in these instances.

Where it's a usual practice to use percentage rentals for similar transactions, be sure to keep your arrangement in line with industry standards. Again, document through independent appraisals and analyses that the terms of your transaction are market-based when you initiate the arrangement. In this fashion, you will be in a far stronger position to justify any unusually high rents that arise in the future. Remember, in most cases with percentage rentals, it will be easier to establish that a particular period's rental amount is reasonable if you can show that the original rental arrangement was arrived at reasonably.

Formal lease. Be sure that your rental arrangement is set down in a formal written lease and is properly executed. Corporations should also take all appropriate formal action related to the transaction. Taxpayers often feel they can relax where the party they are dealing with is related and they don't anticipate future legal challenges. From the tax standpoint, however, it's even more important to undertake the proper formalities for these transactions in the event IRS seeks to disregard them. In several cases, rent paid to a related party has been disallowed because it wasn't required under a formal lease.