Private Letter Ruling 8104004

Retired husband, who files joint return with wife, isn't allowed business expense deduction for rent paid to wife for use of her separate property in community property state as to operation of livestock ranch. Accordingly, he isn't allowed deduction for rent in computing his net earnings from self-employment for purposes of Self-Employment Contributions Act. IRS distinguished REVRUL 74-209, 1974-1 CB 46, on the basis that the spouses therein filed separate returns. IRS concluded that rental transaction lacks economic reality. There was no written lease; husband only started paying rent in 1976, even though he used wife's separate property since 1955; and there was no proof of monthly payments and no explanation of why husband paid two years' rent each year. And, to allow deduction on joint return would contradict express language of Sec. 162(a)(3)

Such allowance would give wife, the person with equity or title in rental property, the benefit of any portion allowed. (Technical Advice Memorandum.)

Whether Husband, who is operating a livestock ranch on his Wife's separate property in a community property state, may pay Wife rent for the use of her separate property and then take a deduction for the rent paid in computing his net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA), chapter 2, subtitle A, Internal Revenue Code. Facts

Before 1976 Husband had two jobs. In 1976 he retired from 'job one' and began receiving social security retirement benefits. He continued to operate the livestock ranch on Wife's separate property, which has been his 'second job' since 1955.

For several years prior to 1976, Wife had been requesting that Husband pay her rent for use of the ranch property. In 1976 Husband agreed to start paying her rent. In 1976 and 1977 he paid her the equivalent of two years' rent in each year. In 1976 she received $38,700 for two years and in 1977 she received $30,000 for two years. It is agreed that the amount of rent was reasonable for the acreage involved.

Husband and Wife filed joint income tax returns using the cash method of accounting for both years at issue, as has been their consistent practice. In both years the rent received by Wife was reported on their joint Form 1040 as rental income and taken into gross income. A similar amount was deducted as an expense of Husband's ranch operation on Schedule F of Form 1040. In 1976 and 1977 net losses of $6,740 and $11,878, respectively, were reported on Schedule F and net losses of $15,970 and $9,868, respectively, for SECA tax purposes were reported on Schedule SE. Thus, no SECA tax liability was reported by Husband for either year.

On audit the examining agent proposed that the rental deductions be disallowed as lacking in substance, thus shifting Husband's self-employment earnings from a net loss to a net gain and

resulting in liability for SECA taxes for both 1976 and 1977. Total taxable income would remain the same but rental income would be decreased, and farm earnings increased by an equal amount. The only tax difference would be the imposition of the SECA tax; however, because social security benefit payments are affected by an individual's earnings under certain circumstances, it is anticipated that Husband's social security benefits would be greatly reduced if his net earnings from the ranch operation are shifted from a net loss to a net gain by disallowance of the rental deductions.

Applicable LAW:

Section 1402(a) of the Code provides that, for SECA purposes, the term 'net earnings from self-employment' includes the gross income derived by an individual from any trade or business carried on by the individual less the deductions allowed by subtitle A of the Code which are attributable to the trade or business.

Section 1402(c) of the Code provides that the term 'trade or business,' when used with reference to net earnings from self-employment, has the same meaning as when used in section 162 (relating to trade or business expenses), with certain exceptions that are not relevant to the issue in this case.

Section 162(a) of the Code, which is part of subtitle A, provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1 of the Income Tax Regulations provides, in part, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Section 162(a)(3) of the Code provides for the deduction of all the rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Rev. Rul. 74-209, 1974-1 C.B. 46, holds that rent paid by a husband to his wife for the use of their jointly owned Wisconsin real estate, that the husband used in his business, is deductible as a business expense on the husband's separate income tax return.

In WAGONER V. COMMISSIONER, No. 13,520 (T.C.M. 1948), the Tax Court held that a wife who paid a salary to her husband for personal services rendered in connection with the management of her separate property was allowed a business deduction on her separately filed tax returns.

Section 1402(a)(5) of the Code provides that if any of the income derived from a trade or business (other than one carried on by a partnership) is community income under community property laws, all of the gross income and deductions attributable to the trade or business are treated as the husband's unless the wife exercises substantially all the management and control of the trade or business.

Rationale

The pivotal question in this case is whether Husband should be allowed a business deduction, under section 162 of the Code, for the rent paid to Wife.

In both Rev. Rul. 74-209 and WAGONER, above, the taxpayer was allowed a business deduction on her separately filed income tax return. However, in the instant case Husband and Wife have jointly filed their income tax return.

The specific language of Rev. Rul. 74-209 and WAGONER indicates that a taxpayer must file separately in order to be entitled to the deduction. The conclusion to be drawn by the inclusion of the words 'separately filed' in the revenue ruling and the court case is that if the husband and wife have not filed separately then no deduction will be allowed.

In PENN V. COMMISSIONER, 51 T.C. 144 (1968), the Tax Court of the United States held that a husband and wife were not entitled to deduct, on their jointly filed tax returns, any sums as 'rent' in respect to their children's property, which husband used for his business. VAN ZANDT V. COMMISSIONER, 341 F.2d 440 (C.A. 5); WHITE V. FITZPATRICK, 193 F. 2d 398 (C.A. 2), CERT. DENIED, 343 U.S. 928, followed.

In determining whether the rent paid, under section 162(a)(3) of the Code, by husband to a family member should be an allowable deduction for the use of family member's property, the Tax Court in PENN determined that in the absence of a written lease, such transaction lacks economic substance. A taxpayer entering into a transaction with members of his family group, without specifically setting forth the consequences of the transaction, without a fixed legal obligation for monthly rental payments and without a change of rights which he did not already have due to intimacy of family relationship and past experience, supports the conclusion that such transaction lacked economic reality and was intended merely as an artificial reallocation of income within the immediate family. VAN ZANDT; FURMAN V. COMMISSIONER, 381 F.2d 22 (C.A. 5).

The facts and circumstances surrounding PENN are relevant to those in the instant case. Husband and Wife do not have a written lease. Husband and Wife have filed joint tax returns. Husband only started paying rent in 1976, although he had been using Wife's separate property since 1955. Husband and Wife have not presented any facts showing monthly rental payments nor have they explained why Husband paid two years' rent each year, thereby casting further doubt upon the bona fides of the entire transaction.

In FRETWELL V. COMMISSIONER, T.C.M. 1979-10, the Service denied a deduction for rental payments on the basis that no portion of the deducted rent could be claimed as having been paid to Mrs. Fretwell as was allowed in Rev. Rul. 74-209, 1974-1 C.B. 46. This is because no evidence was introduced as to the respective interests of petitioners in the property. Also, no actual payment was made to Mrs. Fretwell. And most important, a joint return was filed in each year by the petitioners. To allow any portion of the rental expense on a joint return would be a contradiction of the express language of section 162(a)(3) Such allowance would grant petitioner who did have an equity or title in the house to gain the benefit of any portion allowed. This position was sustained by the Tax Court.

Conclusion
Because Husband and Wife filed joint income tax returns for the years at issue, the rationale of Rev. Rul. 74-209 is not applicable. Furthermore, the rental transaction lacks economic reality and contradicts the express language of section 162(a)(3) of the Code.

Therefore, Husband is not allowed a deduction under section 162 of the Code for the rent paid to Wife; and, accordingly, Husband is not allowed a deduction for the rent in computing his net earnings from self-employment for purposes of the SECA.