Tax Insights & Commentary
Sept. 19, 2023, 1:45 AM

Masters Rule Is Shakier After Tax Court's Home Rental Ruling

The IRS may limit—or even repeal—a tax provision that allows homeowners to exclude income from 14-day property rentals in response to a recent US Tax Court ruling, say Marcum's Jo Anna Fellon and Loredana Scarlat.

The US Tax Court ruling in *Sinopoli v. Commissioner* has spotlighted the Masters rule, a tax provision that allows homeowners to exclude income when renting their properties for up to 14 days annually. This rule, which originated from the Augusta National Golf Club's tournament in Georgia, now faces increased scrutiny in the age of Airbnb Inc. and the proliferation of social media influencers calling it a tax hack.

Understanding the Masters Rule

The surge in accommodation demand during the Augusta National Golf Club tournament led local homeowners to open their homes for short-term rentals. Given the event's fleeting nature, the IRS acknowledged that such temporary rentals shouldn't be considered regular business activity. Although its origins are localized, the rule offers a universal advantage to taxpayers who stay within the 14-day limit, regardless of rental revenue.

The digital era, ushered in by platforms such as Airbnb, has rendered the Masters rule beneficial to several homeowners. However, the *Sinopoli* case reveals the challenges some taxpayers face when employing creative interpretations of this rule.

Sinopoli v. Commissioner

In *Sinopoli*, taxpayers adopted a strategy of renting their homes to their corporation. This dual approach enabled them to claim the rental as a corporate deduction while excluding the same income from personal tax under Section 280A(g) of the tax code, essentially leveraging the Masters rule.

While the company claimed deductions for three monthly meetings across different residences, the evidence presented in the Tax Court didn't support such frequency. The court found documentation, such as meeting minutes or agendas, lacking. When the taxpayers attempted to justify their claims, the court deemed their testimony inconsistent and not credible.

Of the $290,900 in rent the company deducted over almost three years, the Tax Court agreed with the IRS's assertion that this was part of a tax-saving strategy. The court contended that the taxpayers employed this "scheme" to distribute company earnings through "purported rent payments," aiming to claim deductions and exclude this rent from their gross income.

Upon deeper examination, the Tax Court ruled that the IRS's suggested rent of $500 per meeting was generous. The deductions were adjusted to reflect $6,000 for 2015, $6,000 for 2016, and $4,500 for 2017—a total of just $16,500, well short of the taxpayers' $290,900 deduction.

Furthermore, the taxpayers were involved in another financial plan, creating separate companies to channel certain marketing expenses. The IRS disallowed nearly $1 million in expenses for three years, arguing that these were means to transfer earnings for personal use. The Tax Court concurred, further highlighting the risks of aggressive tax strategies.

What Expenses Are Deductible?

Generally, Section 162 of the tax code emphasizes that to be deductible, an expense must be both ordinary (common in your business) and necessary (helpful and suitable for your business). Although marketing and rental expenses arguably meet both these requirements, both arrangements were structured as related-party transactions, so they failed the reasonableness test in that aspect.

The IRS heavily scrutinizes most deals structured as related-party transactions due to their self-serving nature. Most related-party transactions must be arm's-length transactions or, put differently, as close to a market transaction between unrelated parties as possible. Both arrangements failed on this front, as they far exceeded comparable market prices.

The Masters rule offers tangible advantages, but the *Sinopoli* case might indicate a shift in the IRS's stance toward its interpretation. Possible outcomes could include tighter rule enforcement, amendments, or a complete repeal. As tax strategies continue to evolve, staying within the boundaries of the law becomes imperative.

The case is Sinopoli v. Commissioner, T.C., No. 10838-20, 8/14/23.

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Author Information

Jo Anna Fellon is a tax partner at Marcum and the national leader of the firm's private client services practice. Throughout her career, she has contributed to tax, philanthropic gifting, and wealth transfer strategies.

Loredana Scarlat is a director at Marcum with over 14 years of experience in public accounting, providing tax services ranging from small and mid-size companies to high-net-worth individuals, trusts, and estates.