Thinking of Renting Out a Property? Make It Easier with Shared Equity

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Renting your real estate can be a wonderful way to increase your cash flow. However, rental properties can also cause you headaches and add a lot of responsibilities onto you, as landlord. After all, in order to rent your property, you have to deal with tenants and handle their needs. However, it turns out there is a way to share some of that ownership responsibility with your tenants. It’s called shared equity, or a rent-to-own agreement.

The Benefits of Rent-to-Own

Typically, as landlord you are 100 percent responsible for the upkeep of the property. You also take on all of the risk, such as being responsible for a mortgage when you have a vacancy. But, when your tenant shares in the ownership of the property,[1] you keep many of the advantages of owning a rental property and also gain additional benefits.

The benefits aren’t one sided, either. Your tenant shares in equity on the home, as well as putting a down payment on it. And, they get a wonderful opportunity to carefully inspect a home before committing to the purchase (and build equity while making their decision!). The tenants also receive tax deductions that they would not be entitled to as typical renters.

If your agreement gives you 65 percent ownership and the tenant 35 percent ownership, then the tenant pays you rent for your 65 percent. You can treat your share just as you would any other rental property. This arrangement is approved by tax law.

Here are some reasons to consider a rent-to-own situation:

- **The tenant shares responsibility for property upkeep.** Normally, as a landlord, you would be responsible for any necessary repairs, including scenarios like an unexpected breakdown of the refrigerator that needs urgent attention. With shared equity, however, tenants have their own interest in keeping the property in shape, whether they exercise their purchasing option or agree to sell the property with you. The tenant has become tenant-owner, and they should be expected to provide most of the day-to-day repair work, like lawn care. So, you won’t be getting calls in the middle of the night about urgent repairs! In addition, they are less likely to cause damage to floors, walls, or other parts of the property because increasing the property’s value is now their goal as well as yours.
- **You don’t have to worry about vacancies, which cost you money.** Aside from the lost influx of money, you’re also out the money and time spent finding a new tenant

and preparing the property for them. If vacancy goes on for several months or more, it's going to cost you a lot, but a rent-to-own situation ensures that your tenant is in for the long-haul. They're not likely to just give up their share of the equity in a home they live in.
- **You have no management fees.** Management fees are an optional expense, but for many landlords it becomes necessary, especially if you have another job or business. Typically, management companies are hired to take care of things like property inspection, advertising for tenants, and providing or scheduling repairs. With your tenant-owner, none of this is necessary. You have a long-term renter who will more than likely take good care of the property themselves.
- **You tenant has more reason to make their payments on time every month.** In a shared equity situation, your tenant is paying towards an end-goal, whether it's to own the property in entirety or to own their share of the equity at the time of sale. This means that for the duration of the agreement, you know how much rent you will receive and for how long. You also know the possible scenarios for when the rental term comes to an end. Basically, you have a much better idea of your financial outcome than most landlords do.

Your Tax Situation

But, what about the taxes? Here's something you don't hear very often. Tax law regarding shared equity is very straightforward. In fact, for the more than 30 years it's been on the books, there's only one private letter ruling to use as an example (PLR 8410038). In this ruling, the landlord made a 20 percent down payment and took half the mortgage; the tenant took the other half. At the end of five years, their agreement allowed for the tenant to buy out the landlord by 1) reimbursing the down payment and 2) paying 50 percent of what the equity increased by since the beginning of the agreement to the landlord. During those five years, the tenant paid the landlord both a rental fee and 50 percent of the mortgage.

The sharing of expenses is, likewise, straightforward and laid out in tax law. Any tax benefits *must* be divided according to ownership interest. In the above case, both the landlord and the tenant-owner would receive 50 percent of the tax benefits.[2] In addition, for most shared equity situations, the relationship between parties is considered tenants-in-common. That means you'll have to follow state tax laws, which typically require expenses such as repairs, taxes, and interest to also be divided according to ownership interest. Since your tenant will likely be completing repairs, they do have the right to request reimbursement from you for half the cost. Regardless of whether they pay 50 percent or 100 percent, the tenant only gets tax benefits for their vested interest (as do you).[3] Of course, you'll want to check your particular state's tax laws in this area.

Pay attention to how you agree to divide expenses in your equity-share agreement. In one court case, the landlord owned 50 percent of the equity but paid 100 percent of mortgage interest and property taxes on *two* properties.[4] It didn't matter how much he paid; he could only deduct 50 percent from his taxes. Just because each party pays 50 percent of the mortgage doesn't necessarily mean your ownership percentage is 50 percent each. Other factors, such as down payment, can come into play. Always check with an attorney when signing an equity-share agreement.

Calculating the Rent

Tax law also specifies that you and your tenant will need to come to a rental agreement based upon "fair market rent".[5] All of this planning in advance should make you one happy landlord. You're getting a written guarantee of how much cash you'll be receiving for years to come.

As you know, any situation that deals with tax law requires proper documentation. So, be sure to keep a file with all the necessary information. One thing you will need to provide is evidence that your rent price is fair. Some ways to do this are to clip ads for other rentals in the area, print online ads for your area, get a written opinion from a consultant or rental management company, or get information from nearby tenants on what they pay for rent (including their names).

You'll probably do some of this research anyway in order to come to your determination. The key is to *hang on* to your research documents. Research you performed but didn't document don't count for anything with the IRS, and as landlord, you bear the burden of evidence.

Following the Rules

Once you've found the perfect tenant-partner, you'll want to follow three rules in order to comply with tax law.

1. **The equity-share arrangement must be detailed in a written agreement.**[6] This document must include details regarding ownership of the residence by two or more people; agreement that one of the parties must occupy the dwelling as their primary residence; and, agreement to rent payment.
2. **The relationship must be one of joint ownership.** According to tax law, both parties will own the property even after the rental period ends. The tax law technically stipulates a period of 50 years of ownership, but what you really need to know is that you both must, *in fact*, own the property.[7]

3. **Tax benefits are earned according to ownership.** As stated above, you can only claim benefits for your share of ownership in the property.

Before entering a shared equity situation, plan accordingly. You’ll want to choose someone trustworthy to enter into a long-term ownership with. Hire a real estate attorney to help make sure you consider all the possible scenarios, and get everything in writing. And, always, always keep your records. If you do rent-to-own right, you can make renting your property both easier and more profitable.

1. IRC Section 280A(d)(3)(C)(ii)(I). ^
2. Prop. Reg. Sections 1.280A-1(e)(5)(iii)(B)(3); 1.280A-1(e)(5)(iii)(C) Example. ^
3. Estate of Boyd v. Commr., 28 T.C. 564 (1957). ^
4. Joseph J. James v Commr., TC Memo 1995-562. ^
5. IRC Section 280A(d)(3)(B)(ii). ^
6. IRC Section 280A(d)(3)(C). ^
7. IRC Section 280A(d)(3)(D). ^