Due Diligence FAQ

Short-Term Rental (STR) Loophole

Tax Purpose:

Consistent with the firm's existing composite score of 3. 8/10 and "Not Recommended" tier, this strategy should not be recommended as a general-purpose planning tool for the firm's typical high-W2-income tech-employee client.

Mechanics & Key Considerations:

- The strategy proceeds in four linked steps
- First, the taxpayer must take the rental property outside the general rule that rental activities are per se passive under IRC §469(c)(2), regardless of participation level
- Second, clearing the seven-day average-stay hurdle does not by itself make the loss non-passive — it only removes the property from the automatic "per se passive" bucket and puts material participation back in play, per Treas
- Third, once non-passive treatment is secured, the strategy layers on accelerated depreciation to inflate the loss size
- Fourth, if — and only if — both the average-stay exception and a material participation test are genuinely satisfied and defensible, the resulting rental loss is treated as non-passive under IRC §469(a) and (h), and can offset active income including W-2 wages, subject to the ordinary loss limitation rules (e.g.

Key Risks:

- Contemporaneous documentation is the central and non-negotiable risk driver
- Audit-target status
- Depreciation recapture on sale is a real, quantifiable, and frequently underweighted risk
- The "self-rental to yourself for a week" pattern fails for at least three independent reasons: excessive personal use triggers the vacation-home rules of §280A; an average-stay calculation manufactured through non-arm's-length bookings invites a substance-over-form challenge; and it does nothing to satisfy the separate material participation requirement
- Property-manager displacement is a related, everyday risk for this client profile: engaging a full-service manager will very often cause the manager's staff hours to exceed the taxpayer's own, defeating test (3) exactly as occurred functionally in Lucero

Structure:

The "STR Loophole" is a tax-planning strategy in which a client purchases (or converts) real property into a short-term rental — average guest stays of seven days or less — and combines that property's special exception from the passive activity loss rules with a cost segregation study and first-year bonus depreciation under IRC §168(k) to generate a large paper loss that is treated as non-passive and therefore usable to offset the client's active W-2 wages. In principle, the mechanism is real: Treas. Reg. §1.

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Dimension	Score	Why
Legal Risk	**3/10**	The recent, adverse, and closely on-point Mirch v. Commissioner decision, layered on Lucero and the well-established pattern of the Tax Court rejecting reconstructed time logs, means the single most common execution failure (inadequate contemporaneous documentation) is now backed by fresh, unfavorable precedent; a client executing this imperfectly faces real audit and litigation exposure.
Economic Substance	**4/10**	The underlying mechanism (average-stay exception plus a genuine material participation test) is legally real and not a sham, but the economic benefit as typically marketed conflates deduction size (driven by bonus depreciation) with loss character (driven by material participation), and much of the year-one benefit is a timing arbitrage partially clawed back by depreciation recapture on sale.
Realistic ROI	**4/10**	After accounting for cost segregation fees, the burden of genuinely performing and documenting 100+ hours of hands-on work, professional fees for defensible recordkeeping, and prospective §1245/§1250 recapture on exit, the net multi-year benefit is materially smaller than the "generate a six-figure loss" pitch suggests, especially once §461(l) excess business loss limitations are factored in for high-income clients.
Liquidity	**5/10**	The strategy requires committing substantial capital to a directly held, illiquid real property asset with a multi-year holding horizon to avoid short-term recapture and to justify the material participation burden — no worse than other direct real estate strategies but materially less liquid than the client's other likely investment alternatives.
Client Fit	**3/10**	A high-W2-income tech employee with a demanding full-time job is precisely the profile least able to sustain genuine, well-documented, non-outsourced 100–500 hour annual participation; the natural response (hiring a full-service property manager) is the exact fact pattern that has repeatedly failed in Tax Court.

Recommendation:

Consistent with the firm's existing composite score of 3. 8/10 and "Not Recommended" tier, this strategy should not be recommended as a general-purpose planning tool for the firm's typical high-W2-income tech-employee client. The underlying law is legitimate and the strategy can work, but it works only for a narrow subset of clients who are both willing and realistically able to personally perform substantial, genuine, contemporaneously documented operational work — a profile that describes few busy W-2 tech employees.