

Tax Implications of Your Business Renting Property that You Own

Frequently business owners have their businesses rent property which they personally own. There are a variety of reasons to separate the ownership and use of real properties - estate planning needs, liability limitation and accommodating the needs of investors or lenders.

Logic would seem to dictate that, when both the business and the real estate are wholly owned by the same person, there should be no tax consequences. The owner is basically paying rent to himself, so the transaction has no economic substance.

Logic Superseded by IRC 469

However, applying IRC 469 can often result in a different outcome. IRC 469 was adopted to prevent shifting of active business income to passive income. It applies to C corporations that are subject to section 469, as well as S corporations and partnerships.

IRC 469 states that if a loss results from a separate activity of renting real property to the owner's business entity, it is classified as a passive loss. However, net income from property rented by a taxpayer to a trade or business in which the taxpayer materially participates is not treated as passive income. The application of this ruling produces interesting results.

Passive Loss not Applicable to other Nonpassive Income

Consider a taxpayer who rents an industrial building to an S corporation that he wholly owns. The taxpayer is not a real estate professional because he spends more than 50% of his time conducting his manufacturing business. As a result of high repair costs, the taxpayer lost \$100,000 on the rental of his property in year one. Because the rental activity is a per se passive activity, the taxpayer is limited to deducting a special allowance of \$25,000 against nonpassive income. The remaining \$75,000 is carried over to the following year as a passive loss if the taxpayer has no additional passive income.

The \$25,000 special allowance applies to those who are at least a 10% owner of the property and actively participate in the management of the property. It is limited if the owner's modified adjusted gross income exceeds \$100,000.

In the subsequent year the rental property produces a \$30,000 profit. Because the profit is recharacterized as nonpassive income under IRC 469, the taxpayer is only allowed to use \$25,000 of the prior year suspended passive loss, due to the special allowance rules, and carryover the remaining \$50,000 loss.

Recharacterized Rental Income

Another interesting example involves a taxpayer who owns both an industrial building and an apartment building; he is the sole owner of an S corporation engaged in

manufacturing which in turn rents the industrial building. He realized \$50,000 in net income from the rental of the industrial property, but lost \$50,000 on the apartment building. The taxpayer cannot offset the loss against the gain, because the gain is considered nonpassive under IRC 469. Because the taxpayer is not a real estate professional, the apartment building loss is considered passive. All the taxpayer can do is to apply the \$25,000 special allowance to the loss from the apartment building and then carry over the remaining \$25,000 as a passive loss to the following year.

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Editor's Note --- Kim is a Manager in the firm's Grove City office. She presented the material included in this article originally as a component of tax seminars presented to other professionals and sponsored by the Land Grant University Tax Education Foundation, Inc.