Avoid the Self-Rental Trap

Let's say you own the building.

Now, let's say that you rent this building to your business.

With no tax planning, you have a self-rental, and that

- makes rental income from this building nonpassive, meaning that it cannot offset any passive losses (very bad); and
- makes rental losses from this building passive losses, meaning that you likely cannot deduct the losses this year (also very bad).

So, there you have it: with no tax planning, you get the worst of both worlds.

Solution

But wait—there's a solution (often overlooked).

Under a special grouping rule, you can qualify to group your separately owned rental building with your separately owned business and treat the two of them as one activity for purposes of the passive loss rules.

Ownership

Rental. Your ownership of the rental might be as an individual, an S corporation, or an LLC. For this strategy, you can use any of these forms for your ownership.

Business. You can own the business as a proprietorship, an S corporation, or an LLC—all these forms work for this strategy.

Note that the C corporation does not work. More on this later.

Two into One

What makes two into one possible? Your ownership!

The regulations say that if each owner of the business has the same proportionate ownership interest as each owner of the rental, then the taxpayers may group the business and rental activities as one activity.

Technically, the rental and the business need to pass the *appropriate-economic-unit* test, which gives great weight both to the extent of common control and to the extent of common ownership.

You have no problem here because you have both 100 percent control and 100 percent ownership of both the business and the rental. This puts you home free on this test.

And if you are married, you can include your spouse in the mix.

Example

Harvey and Wilma Johnston are married and file a joint tax return.

Harvey owns an S corporation that operates his dental practice.

Wilma owns a single-member LLC that owns the building it rents to Harvey's dental practice.

Because Harvey and Wilma file a joint tax return, they are treated as one taxpayer for purposes of the passive loss rules. Thus, under the passive loss rules:

- Harvey owns 100 percent of both the dental practice and the rental building.
- Wilma owns 100 percent of both the dental practice and the rental property.

For purposes of the passive loss rules, Harvey and Wilma may elect to group the dental practice and the rental property into one activity.

Say Harvey and Wilma make the grouping election when the dental practice earns $300,000 in net income and the rental property shows a $100,000 loss. Because of the grouping election, the Johnstons' net taxable income for the year is $200,000.

In this special grouping, the IRS allows the rental property passive loss to offset the dental practice active income.

Special Rule for Personal Property

In general, you may not group your personal property and real property rental operations.

So, the workaround is to provide personal property in connection with a real property rental.

Let's go back to Harvey and Wilma for a moment. Say Wilma has her single-member LLC include a refrigerator, a dishwasher, and a stove in the building rental. In this case, the Johnstons do not have to make a separate breakout of the personal property when making the election to group the rental with the business activity.

Another Example

Now say Wilma's S corporation rents space not only to Harvey's dental practice, but also to Jim Miller's insurance business and Sam Levin's accounting business. Say further that each rental block takes one-third of the building.

In this example, Harvey and Wilma can elect to group the one-third that's commonly owned. Most likely, the Johnstons will have to treat the other two-thirds of the building as a rental business subject to the passive loss rules for rentals.

But the ability to treat the one-third as one activity creates the tax advantages that Harvey and Wilma were looking for from the self-rental.

Beware: C Corporation Fails

The IRS says it with the greatest clarity: "No grouping of a rental with a C corporation ever. Rentals can be grouped with a C corporation only to determine material or significant participation."

Election

If you qualify to group your self-rental with your business, you need to make a formal election to let the IRS know what you are up to. The election rules are specified in Revenue Procedure 2010-13.

The election statement must identify the names, addresses, and employer identification numbers (if applicable) for the trade or business activities or rental activities that are being grouped as a single activity. Here is some sample text for such an election (you would attach the statement to your tax return):

[Taxpayer name and taxpayer number]
[Rental property address]
[Business name and business taxpayer number]
[Business address]

Taxpayer owns 100 percent of both the rental property and the business above and hereby elects as set forth in IRS Reg. Section 1.469-4(d), to group the rental property and the business for purposes of IRC Section 469.

Takeaways

You don't have to suffer self-rental rules, which make your rental losses not deductible, when you own the property that you rent to your corporation.

You can, in fact, benefit from the grouping rules when you have a self-rental, just as Harvey and Wilma Johnston benefited (as described in this article).