Abstract: A business owner who also owns real estate may be tempted to lease that property to the company. Unfortunately, for owners of pass-through entities, doing so may trigger the "self-rental rule" and might lead to negative tax consequences. This article explains the details of the self-rental rule plus a way to avoid triggering it.

Leasing property to your business might trigger undesirable tax consequences

If you own property and a business, there's an obvious temptation to lease that property to the business. Such an arrangement can make sense from many perspectives.

You're no doubt familiar with the property and its advantages to your company; the deal could be carried out quickly; and the money changing hands would stay between you and your company. And if you participate in other loss-producing passive activities, you may be hoping to offset the net rental income with those losses.

There's just one big problem: You'd risk triggering the "self-rental rule" and not achieving your desired tax outcome.

Self-rental rule in a nutshell

Internal Revenue Code (IRC) Section 469 generally prohibits taxpayers from deducting passive activity losses (PALs).

It typically applies to "flow-through" income and losses from partnerships, limited liability companies (if they've elected to be treated as a partnership for tax purposes), S corporations and trusts.

The rules define "passive activity" as any trade or business in which the taxpayer doesn't materially participate. Rental real estate activities generally are considered passive activities regardless of whether the taxpayer materially participates. (There's an exception if the taxpayer qualifies as a real estate professional.)

A PAL is the amount by which the taxpayer's aggregate losses from all passive activities for the year exceed the aggregate income from all of those activities. A PAL can usually be used only to offset passive income, though there are a few exceptions.

The self-rental rule in IRC Sec. 469 applies when you rent property to a business in which you or your spouse materially participates. Under the rule, any net rental losses are still considered passive, but the net rental income is deemed nonpassive. That means your net rental income can't be offset by other passive losses, yet net rental losses generally can offset only other passive income. This could have negative tax consequences if you're hoping to offset your self-rental net income with passive losses from other activities.

The power of grouping

You may be able to avoid the negative tax consequences of IRC Sec. 469's self-rental rule by "grouping." The regulations allow you to group your separately owned rental

building with your business to treat them as one activity for purposes of the passive loss rules if they constitute an "appropriate economic unit."

The regulations determine this based on factors such as common ownership and control, types of activities and location. As long as you materially participate in the business — and the business isn't a C corporation — the rental activity won't be treated as passive for the purposes of income or losses.

To take advantage of this option, you must own both the rental property and the business. You could also use grouping if the rental activity is "insubstantial" (a term undefined by the regulations) in relation to the business activity.

Finding the best arrangement

Renting property to a business in which you materially participate can seem like a great idea. But doing so can turn out to be a lose-lose proposition when it comes to taxes — particularly for S corporation owners who may not understand the rules. Please contact our firm for help devising the most beneficial arrangement for your situation.

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