S Corporation Corner

Application of Self-Rental Rules to S Corporation that Leases to Business in Which Shareholder Materially Participates

By Nelson Toner

The Tax Reform Act of 1986 added the passive activity loss rules to the Internal Revenue Code ("the Code").[1] One purpose of these rules was to limit the use of a tax shelter (especially real estate tax shelters) to produce significant tax deductions and credits that could then be used to reduce the tax liability arising from another activity.[2] The scope of these passive activity loss rules permeates many other provisions of the Code, sometimes in ways that could not be foreseen in 1986. The recent case of *L. Williams*[3] exposes one the remaining open issues with respect to the interpretation of the passive activity loss rules and their application to an S corporation and its shareholders. Specifically, the taxpayers asked the Tax Court to interpret the self-rental rules[4] when an S corporation controlled by the taxpayers leased commercial property to a related C corporation. The case provides a good example of the continuing vagaries of Code Sec. 469 and its interpretation when applied to an S corporation.

Any review of the *Williams* case must begin with a brief review of the passive activity loss rules. In general, any loss arising from a passive activity can only be used to offset the income from passive activities and cannot be used to offset income from nonpassive activities.[5] Of course, there are several important exceptions to this limitation on the use of losses from a passive activity.[6] The passive activity loss rules specifically apply to any individual, estate, trust, closely held C corporation and personal service corporation.[7] For these purposes, a closely held C corporation is a corporation where at any time during the last half of the tax year, more than 50 percent in value of its stock is owned, directly or indirectly, by five or fewer individuals.[8] A personal service corporation is a corporation where the principal activity is the performance of personal services, such as legal or accounting services, and the personal services are substantially performed by employee-owners.[9] There is no mention that the passive activity loss rules apply directly to an S corporation.

A "passive activity" is any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate.[10] In general, any rental activity constitutes a passive activity.[11] A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis.[12] In order to determine if

NELSON TONER is a Shareholder in the firm of Bernstein Shur in Portland, Maine.

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a closely held C corporation or a personal service corporation materially participates in an activity, the activities of the owners are considered. For example, if one or more shareholders holding stock representing more than 50 percent (by value) of the stock of the corporation materially participate in the activity, then the entity is treated as materially participating.[13]

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The passive activity loss rules specifically authorize the promulgation of "necessary or appropriate" regulations to carry out the provisions of Code Sec. 469, including among other topics, regulations that specify what constitutes an activity, material participation or active participation for the purposes of Code Sec. 469.[14] The regulations issued under Code Sec. 469 are substantive regulations. Substantive regulations are a binding interpretation of the particular Code section for the IRS.[15] Pursuant to this broad authorization, the Treasury issued regulations describing seven tests to determine if an individual materially participates in an activity.[16] In addition, under this broad authorization, the Treasury issued regulations dealing with the character of net rental income arising from the rental of real estate to a business in which the taxpayer materially participates. These rules are called the "self-rental" rules.[17] In the *Williams* case, the Tax Court was asked to determine whether the net rental income allocated to the taxpayers as the shareholders of an S corporation should be re-characterized from passive activity income (as reported by the taxpayers) to nonpassive activity income (as argued by the IRS) under the self-rental rules.

The purpose of the self-rental rules is to change the character of net rental income from passive to nonpassive for purposes of Code Sec. 469 when there is a relationship between the lessor of the property and the business leasing the property. Specifically, the self-rental rule states that an amount of the taxpayer's gross rental activity income for the tax year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if (1) the property is rented for use in a trade or business (2) in which the taxpayer materially participates for the tax year.[18] In simpler terms (perhaps), if the taxpayer rents property to a business in which the taxpayer materially participates, then the net rental income is nonpassive income. Thus, the regulations have created an exception to the general rule that net rental income is passive income. If the self-rental rules did not exist, then a taxpayer could create passive income from the rental of property to a business in which the taxpayer materially participated and use the passive income to offset passive losses from other sources. Now, the question of who is the "taxpayer" under the self-rental rules is the focus of the ruling in the *Williams* case.

In the *Williams* case, Husband and Wife owned all of the outstanding stock of Real Estate Corporation, an S corporation. They also owned all of the outstanding stock of Medical Corporation, a C corporation. The facts of the case state that Husband materially participated in the business of Medical Corporation and was not a real estate professional under Code Sec. 469(c)(7). Real Estate Corporation leased commercial real estate to Medical Corporation, and Medical Corporation used the leased commercial real estate for its practice. Real Estate Corporation realized net rental income from the rent of the commercial real estate to Medical Corporation and allocated this realized net rental income to Husband and Wife. Husband and Wife reported the net rental income as passive activity income. The IRS audited the return of Husband and Wife and reclassified the net rental income from the rent of the commercial real estate as nonpassive income in accordance with the self-rental rules. Specifically, the IRS found that: (1) the Real Estate Corporation rented the commercial real estate to Medical Corporation, and (2) Husband materially participated in the business of Medical Corporation and therefore the two components of the self-rental rules had been satisfied.

Husband and Wife countered the IRS position with two arguments. First, they argued that Code Sec. 469, on its face, does not apply to an S corporation and second, they argued the self-rental rules do not apply because the lessor of the commercial real estate, Real Estate Corporation, did not materially participate in the business of Medical Corporation.

The Tax Court ruled for the IRS and disagreed with both arguments presented by the taxpayers. With regard to the first argument, since an S corporation is a flow-through entity (most of the time), it does not have to be listed as one of the persons subject to the passive activity rules. Rather, it is the individual shareholders of the S corporation that are subject to the passive activity loss rules because the income from the S corporation is allocated to the individual shareholders and is reported on their individual income tax returns.

With regard to the second argument, the Tax Court found that the self-rental rules apply to the rental transaction because both components of the self-rental rules were satisfied. First, property was rented to Medical Corporation, and second, Husband materially participated in the business of Medical Corporation. The taxpayers raised an interesting argument about the appropriate interpretation of the two components of the self-rental rules. They argued that Real Estate Corporation (and not Husband) was the lessor-taxpayer referenced in the self-rental rules, and because Real Estate Corporation did not materially participate in the business of Medical Corporation, the second component of the self-rental rules was not satisfied. For support, the taxpayers cited *F.J. Dirico*.[19] In the *Dirico* case, the Tax Court rephrased the second requirement to require that "the lessor-taxpayer must materially participate in the business."[20] The Tax Court disagreed with the taxpayer's interpretation and noted that the Tax Court added the term "taxpayer-lessor" to be consistent with the facts as presented in the *Dirico* case. The Tax Court could find no authority that Real Estate Corporation, as a flow-through entity, must materially participate in the business of Medical Corporation. The Husband materially participated in the business of Medical Corporation and was subject to the passive activity loss rules. Therefore, the second requirement of the self-rental rules was met. The net rental income from the lease of the property from Real Estate Corporation to Medical Corporation was nonpassive income.

The fact pattern in the *Williams* case is simple. Husband and Wife own all of the stock in Real Estate Corporation, and they own all of the stock in Medical Corporation. Husband materially participates in Medical Corporation. The net rental income that Real Estate Corporation receives from the rental of the commercial property to Medical Corporation and allocates to Husband and Wife is nonpassive income under the self-rental rules.

Because the facts in the *Williams* case are simple, let's use the resolution of the *Williams* case as an incubator to analyze the tax consequences of the next cases that could arise with more complicated facts. Assuming all of the other facts remain the same, what will happen if Medical Corporation has multiple owners and Husband and Wife do not control it? The self-rental rules have two components: (1) Real Estate Corporation must rent the commercial real estate to Medical Corporation, and (2) Husband must materially participate in the business of Medical Corporation. Even if there are multiple owners of Medical Corporation and Husband and Wife do not control it, Real Estate Corporation rents commercial real estate to Medical Corporation for the operation of its business, and Husband still materially participates in the business of Medical Corporation. Therefore, the two components of the self-rental rules are satisfied, and the net rental income received by Real Estate Corporation and allocated to Husband and Wife is nonpassive income.

Assuming all of the other facts remain the same, what will happen if Real Estate Corporation has multiple owners other than Husband and Wife, and Husband and Wife do not control it? In the *Williams* case, there was no need to distinguish the character of the income received by the separate shareholders of Real Estate Corporation. Husband and Wife owned all of the stock, and Husband materially participated in the business of Medical Corporation. In this hypothetical, the shareholders of Real Estate Corporation (other than Husband and Wife) do not materially participate in the operations of Medical Corporation. Do the self-rental rules apply to the net rental income that is allocated to them? Or should the tax analysis look at the participation of each shareholder in the activities of Medical Corporation? The regulations and the S corporation rules provide guidance and, I surmise, the answer. Under its broad authority, the Treasury issued regulations concerning the rules for the grouping of activities under the passive activity loss rules. In particular, the regulations state that a taxpayer's activities include those conducted through an S corporation.[21] So, an activity of an S corporation shareholder includes the activities of the S corporation. Stated another way, the activities of an S corporation are attributed to the shareholders. In the *Williams* case, Husband conducted the activity of renting property to Medical Corporation through his S corporation, Real Estate Corporation. Second, the character of the net rental income received by an S corporation passes through to its shareholders.[22] Code Sec. 1366(b) provides that the character of any income allocated to the shareholder of an S corporation shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation. Therefore, a shareholder of an S corporation determines the character of an item of income that is allocated to the shareholder as if the shareholder had realized the item of income directly. In the *Williams* case, the Husband is treated as if he realized the net rental income from Medical Corporation. Therefore, with regard to each shareholder of Real Estate Corporation, the proper tax treatment is determined as if the shareholder had directly rented the commercial property to Medical Corporation. With regard to Husband and Wife, the self-rental rules are satisfied and the net rental income allocated to them is nonpassive income because Real Estate Corporation rents commercial real estate to Medical Corporation for its operations, and Husband materially participates in the business of Medical Corporation. With regard to the other nonmaterially participating shareholders, both parts of the self-rental

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rules are not satisfied, and, therefore, the net rental income is passive income.

The result of the *Williams* case is not earth-shattering. However, the analysis of the case reminds us that the vagaries of the interpretation of Code Sec. 469 as it applies to S corporations will continue to entertain tax practitioners for years to come.

ENDNOTES

1 Act Sec. 501(a) of the Tax Reform Act of 1986 (P.L. 99-514) added Code Sec. 469.
2 General Explanation of the Tax Reform Act of 1986, page 209.
3 *L. Williams,* 109 TCM 1398, Dec. 60,290(M), TC Memo 2015-76 (hereinafter, the "*Williams* case").
4 *See* Reg. §1.469-2(f)(6).
5 Code Sec. 469(b).
6 For example, under Code Sec. 469(c)(7), the passive activity loss rules do not apply to a real estate professional.
7 Code Sec. 469(a)(2).
8 Code Sec. 469(j), *citing* Code Sec. 465(a)(1)(B).
9 Code Sec. 469(j)(2).
10 Code Sec. 469(c)(1).
11 Code Sec. 469(c)(2).
12 Code Sec. 469(h)(1).
13 Code Sec. 469(h)(4).
14 Code Sec. 469(l).
15 Code Sec. 7805(a).
16 Reg. §1.469-5T(a).
17 Reg. §1.469-2(f)(6).
18 *Id*.
19 *F.J. Dirico*, 139 TC 396, Dec. 59,253 (2012).
20 *Id*., at 404.
21 Reg. §1.469-4(a).
22 Code Sec. 1366(b).

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