Don’t Miss Cost Segregation Tax Deductions

AUGUST 20, 2013

In some cases, rather than renting space, a business owner may purchase the buildings in which they operate their companies.

Many CPAs who work with these types of business owners feel their clients are passive investors and cannot take advantage of cost segregation. In reality, many of these property owners can benefit from cost segregation tax savings if the accountant knows what to look for.

The first thing to address is whether or not the tax loss for the owner of two Subchapter S corporations is limited by the Tax Code’s Section 469 passive activity loss rules when one Subchapter S corporation (entity 2) rents commercial real property to another Subchapter S corporation (entity 1) and the real property is used in entity 1’s trade or business?

The answer: Probably not. Generally, passive losses can only offset passive gains and active losses can only offset active gains. Losses that would otherwise be passive can be active by applying the self-rental rule and/or the grouping rules. Here, the self-rental rule converts the rental income from entity 2 to active income.

The self-rental rule does not convert the rental loss from entity 2 to an active loss. But, if a timely election is made by the owner to group the activities, and the activities constitute an appropriate economic unit, the otherwise passive rental loss from entity 2 could be an active loss that can be used to offset the active income from entity 1. This grouping may be possible by applying the special rules for when the rental activity is insubstantial in relation to the trade or business (e.g., the income from the rental activity is less than 20 percent of the income from the professional service firm) and, alternatively, the individual owners have the same proportional interest in both entities/activities.

For example, let’s say, entity 1 is a professional service corporation. Entity 1 is a Subchapter S corporation. Entity 1 earned approximately $9 million in fees for services in the current year. Entity 2 is a real estate holding company and also a Subchapter S corporation. Entity 2 owns one commercial rental property. Entity 2 acquired the property in the current year and rented the property primarily to entity 1. Entity 2 received approximately $800,000 in rental income from Entity 1 in the current year. The rental payments are at market rates prevailing in the local area. Despite receiving rental income, entity 2 incurred a tax loss through a cost segregation study by accelerating depreciation.

Entity 1 and entity 2 are owned by the same individuals and the individuals own the same proportionate ownership interest in both entities. The individual owners materially participate in entity 1. Neither entity 2 nor its owners have filed federal income tax returns for the current year.

The Law

The Tax Code's Section 469 passive activity loss rules can limit the amount of tax losses that would otherwise be deductible. To the extent losses are not allowed in the current year pursuant to the passive activity loss rules, the losses are generally carried forward and are used the next tax year to offset passive activity gains.

A passive activity loss arises when otherwise deductible expenses for a passive activity exceed the income from the passive activity.

The term "passive activity" means any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate (Section 469(c)(1)). Passive activities generally include any rental activities (Section 469(c)(7)). For example, this would generally include rental income earned by a rental holding company.

Conversely, non-passive activities include activities that involve the conduct of any trade or business in which the taxpayer materially participates and, generally, are not rental activities. For example, this would generally include earnings from a professional service corporation for professional services.

There is a special rule for income (not losses) from real estate rented to a trade or business in which the taxpayer materially participates (Treasury Reg. Section 1.469-2(f)(6)). This self-rental rule re-characterizes the otherwise passive income to active income, which cannot be used to offset other passive losses. This rule does not apply to real estate rented to a rental activity, i.e., real estate that is not rented to a trade or business in which the taxpayer materially participates (Dirico v. Comm'r, 139 T.C. No. 16). This scenario is where a taxpayer rents radio towers to its Subchapter S corporation that in turn rents the radio towers to its customers. The Subchapter S corporation's activities are rental activities and not a trade or business activity.

A taxpayer can carry on one or more activities, including both passive and non-passive activities with a single entity or in multiple entities. Taxpayers can generally elect to group activities, even those carried out by different entities, if they form an appropriate economic unit for purposes of determining gain or loss (Treas. Reg. Section 1.469-4(c)(1)). There are a number of factors that are considered when determining whether activities are to be grouped as an economic unit, such as the similarities and differences in the types of activities, extent of common control, extent of common ownership, geographic location of the activities and interdependence between activities.

All factors are not necessary and whether activities are grouped as an economic unit depends upon the facts and circumstances (Treas. Reg. Section 1.469-4(c)(2)).

Rental activities generally cannot be grouped with a trade or business in which the taxpayer materially participates unless (1) the rental activity is insubstantial in relation to the trade or business or vice versa or (2) the owners have the same proportionate ownership interest in the rental activity as they do in the trade or business (Treas. Reg. Section 1.469-4(d)(1)).

Example 1 in Treas. Reg. Section 1.469-4(d)(1) addresses proportionate ownership. It provides as follows:

i. H and W are married and file a joint return. H is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. W is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to H's grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business are not insubstantial in relation to each other.

ii. Because they file a joint return, H and W are treated as one taxpayer for purposes of Section 469. See Section 1.469-1T(j). Therefore, the sole owner of the trade or business activity (taxpayer H-W) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together (under paragraph (d)(1)(i) of this section) into a single trade or business activity, if the grouping is appropriate under paragraph (c) of this section.

Generally, activities are considered to be separate unless a written election to group activities is made on a timely filed original tax return (Treas. Reg. Sections 1.469-9(g), 1.469-11(a)(3)).

Analysis

Entity 1 is carrying on a non-passive activity and entity 2 is carrying on a passive activity. As such, under the general rules, a loss incurred by the owners of entity 1 and 2 stemming from the rental activities of entity 2 would be passive and limited by the Section 469 passive activity loss rules. The self-rental rule would convert entity 2’s rental income into active income.

If a timely election to group is made by the taxpayer and the activities constitute an appropriate economic unit, the trade or business activities of entity 1 and rental activities of entity 2 may be grouped as one activity. This may be possible given the special rules for when (1) the rental activity is insubstantial in relation to the trade or business (e.g. the income from the rental activity is less than 20 percent of the income from the engineering services) and, alternatively, (2) the individual owners have the same proportional interest in entity 2 (the rental activity) as they do in entity 1 (the professional service corporation).

This is in line with the U.S. Tax Court’s recent findings in Dirico v. Comm’r, 139 T.C. No. 16. Unlike the present facts, in Dirico, the taxpayer did not use the bulk of the rental property in its trade or business. The taxpayer used the bulk of the rental property in its rental activities, by re-leasing the property to its customers. Moreover, the *de minimis* amount of property the taxpayer used in its trade or business was provided rent-free to its customers. In other words, the property was not actually used in the taxpayer's trade or business.

The facts described in this memo are different than those described in Dirico. Here, entity 1, the professional service corporation, uses the commercial real estate in its trade or business. Thus, as noted by the taxpayer in Dirico and as described in example 1 in Treas. Reg. Section 1.469-4(d)(1), the taxpayer would group the rental activities with the business activities—not with another rental activity. Thus, neither the income nor the rental losses generated by entity 2 are limited by the passive activity loss rules for the individual owners.

This is an area of tax law where having a very strong understanding of the tax and case law is important. While not the case for everyone, many business owners who also own the buildings where they conduct their business are missing out on a great deal of tax savings because many assume they can't take advantage of cost segregation. It often pays to consult with a cost segregation expert in complicated cases and your clients will appreciate that you did.