

Dealings With Owner

Tax Info Sheet (2010)

RENTALS WITH OWNERS

Advantages of C Corporation Shareholders Receiving Rents and Royalties From Their Business

Avoiding Payroll Taxes	Rental income from real estate is exempt from the self-employment (SE) tax. Rental income from personal property may be exempt from SE tax. Royalties are not subject to SE tax unless earned in an activity that is a trade or business.
Avoiding Corporate-Level Gain	Retaining ownership of real estate and other tangible or intangible assets with high probability of appreciating outside the corporation avoids the potential for triggering corporate-level gain when those assets are sold or distributed.
Retirement Cash Flow	Retaining valuable assets outside a closely held corporation allows the shareholder-lessor to continue to receive cash flow from the corporation in the form of rents or royalties, even though the shareholder sells or is no longer actively employed by the corporation.
Business Transition	Retaining assets outside the corporation allows ownership of the business entity and the ownership of business assets to be segregated. For example, a controlling shareholder-lessor may want to dispose of some or all of the corporate stock but retain a significant portion of the business assets for lease to the entity. This can help transfer ownership and control to the successor generation by minimizing the corporation's value (that is, the corporation contains only operating assets such as receivables and inventory, with fixed assets owned individually by a passive or investor shareholder).

Potential Traps When Paying Rents to C Corporation Shareholders

Reasonableness of Rent	Rental payments that are too high in relation to the property's fair rental value face possible reclassification as constructive dividends or compensation. Rents that are too low face the possibility of IRS imposing constructive receipt of rental income (creating income that wasn't actually received).
SE Tax Risks of Equipment Rental	Real estate rentals and personal property that is leased with real estate is exempt from SE tax. However, SE tax applies to personal property leased to a corporation if the leasing activity is considered a trade or business of the lessor.
Passive Income Recharacterization for Self-Rental	Net rental income (gross income net of expenses) is recharacterized from passive to nonpassive. Therefore, other passive losses cannot be used to offset this income.
Timing Rule	An accrual basis closely held corporation cannot deduct lease payments payable to a cash basis individual owner until the amount is includable in income of the owner.

OWNER DEBT

Advantages of C Corporation Debt Owed to Owners


Advantage	Description
Interest Deduction	The interest payments to the owner from the corporation are deductible by the corporation, allowing cash payments to the owner without the double taxation burden of dividends or the payroll tax burden of compensation. However, the interest is not deductible until includable in the shareholder's income.
AET Avoidance	The requirement for a corporation to make debt payments can be used as a legitimate reason for the corporation to retain earnings without being exposed to the accumulated earnings tax (AET). The AET prevents C corporations (other than personal holding companies) from accumulating taxable income indefinitely and without economic need.
Cash Extraction	Loan principal payments are recovered tax-free by the owner.
State Tax Savings	Owner debt may reduce the corporation's franchise tax liability because in many states, the franchise tax is based on the net asset value of the company (unless the particular state requires owner-provided debt to be added back to equity for franchise tax purposes).

Advantages of Owner Debt Issued to Pass-Through Entities

- Owners can fund the business capital needs without altering their ownership percentages.
- Potential franchise tax savings in states that tax the entity on its equity.
- Owners obtain an increase in the tax basis of their ownership interest to allow deductions for pass-through losses.


PARTNER HEALTH INSURANCE PREMIUMS PAID BY PARTNERSHIP

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as distributions to the partner, the partnership cannot deduct the premiums.

 **Note:** A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income on Form 1040. However, the partner cannot deduct the premiums for any calendar month or part of a month in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner or the partner's spouse.

PAYING PARTNERSHIP EXPENSES

Individual partners are often required to incur business expenses that will not be reimbursed by the partnership (travel, entertainment, etc.). Partners are generally not entitled to deduct partnership expenses on their individual income tax returns. However, if the partnership's agreement or practice requires a partner to pay certain partnership expenses from his own funds, with no right to reimbursement from the partnership, the partner is entitled to deduct (above the line, in arriving at AGI) these as trade or business expenses on his personal return.

 **Strategy:** Partners should make explicit the "requirement" that partners incur partnership expenses without right of reimbursement, either as a provision of their partnership agreement or through a written policy of the partnership.