JOURNAL OF ACCOUNTANCY

TAX MATTERS

Telecommunication tower leases not subject to self-rental passive income rule

BY JANET A. MEADE, CPA, PH.D.
FEBRUARY 2013

The Tax Court determined that a taxpayer's rental income from the lease of land and telecommunication towers to his wholly owned S corporation was not subject to the "self-rental rule" of Regs. Sec. 1.469-2(f)(6). Accordingly, the court held, the IRS's recharacterization of the income as nonpassive was inappropriate. The court, however, agreed with the IRS on the character of rental income from land without towers, holding that the 30% test of Temp. Regs. Sec. 1.469-2T(f)(3) required it to be treated as nonpassive-activity income.

In 2004 and 2005, the years at issue, Francis Dirico leased land and telecommunications towers to his wholly owned S corporation. In exchange, he received a percentage of the S corporation's revenues from its leasing of tower access to its customers. While the majority of the leases were of land and towers, three were of land only. Dirico sustained net losses on four of the leases of land and towers. On his tax returns he reported each of the individual leases as separate passive activities. Income from the profitable leases therefore offset losses from the unprofitable leases. He also reported the entire amount of his distributive share of income from the S corporation as ordinary business income, which was its character on the Schedule K-1 issued to him.

Sec. 469 defines a passive activity as either an activity involving the conduct of a trade or business in which the taxpayer does not materially participate or a rental activity. It further limits deductions of losses from passive activities to the extent of passive income. Under the self-rental rule of Regs. Sec. 1.469-2(f)(6), rental income received for the use of property in a trade or business activity in which the taxpayer materially participates is treated as nonpassive-activity income. This rule equalizes the tax treatment of taxpayers who place property used in their business in a separate entity with those who retain the property in the same entity as the business operations. It also prevents them from artificially creating passive income to offset losses from other passive activities. The rule, however, does not cover losses from a self-rental activity; those are still passive losses deductible only to the extent of passive income.

The IRS asserted that the income from the land and tower leases to the S corporation was from property used in a trade or business in which Dirico materially participated. Thus, it applied the self-rental rule to recharacterize the income from the profitable leases as nonpassive-activity income, but not the losses. It then argued that the income from the land-only leases was nonpassive because that characterization is required under Temp. Regs. Sec. 1.469-2T(f)(3) when less than 30% of the unadjusted basis of leased property is subject to depreciation. The overall effect of the IRS's adjustments was to disallow the losses from the unprofitable leases, while taxing the income from the profitable leases.

The Tax Court determined that the applicability of the self-rental rule depended on whether the S corporation used the leased land and towers in a trade or business activity. According to the court, the leasing of tower access to third-party customers was clearly a rental (not a trade or business) activity, and Dirico's participation in the activity consequently was irrelevant, as the self-rental rule did not apply. The erroneous reporting on Dirico's Schedule K-1 of the entire amount of the S corporation's income as ordinary business income did not alter the underlying facts. However, since the land-only leases were not provided in connection with any of the leased towers, the court found that they needed to be grouped separately from the land and tower leases under Regs. Sec. 1.469-4(d)(2). Application of the 30% test was therefore appropriate, and because less than 30% of the unadjusted basis of the

land-only leases was depreciable, the income from those leases was characterized as nonpassive-activity income.

Although not discussed in the case, the question of whether income is properly characterized as passive takes on added importance with the new 3.8% Medicare tax on net investment income scheduled to begin in 2013. Tax advisers should consider the implications of this tax when determining the appropriate grouping of separate activities.

Dirico, 139 T.C. No. 16 (2012)

*By **Janet A. Meade**, CPA, Ph.D., associate professor, University of Houston.*
