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For a variety of reasons, many small businesses are structured as regular corporations rather than S corporations, partnerships or limited liability companies (LLCs). A key feature distinguishing the regular corporation from other entities is that the corporation and its shareholders are subject to double taxation. One advantage of owning real estate outside a corporation is to partially avoid double taxation. Other advantages include reducing payroll taxes, shifting income to low-tax-rate family members and protecting assets from corporate creditors.

Double taxation. Corporate profits are taxable at rates ranging from 15 to 39 percent. When profits are distributed to shareholders as dividends, they are taxed a second time at rates as high as 39.6 percent.

This double taxation occurs because dividends are not deductible by the corporation, and paying dividends does not reduce corporate taxable income. However, rents paid to use real estate are ordinary deductible expenses just like advertising or utilities expenses. Thus, shareholder-owned real estate leased by the corporation provides the opportunity for the corporation to pay deductible rents to the shareholder rather than non-deductible dividends, thereby avoiding double-taxation. If the property is later sold at a gain, the gain also avoids tax at the corporate level.

Payroll taxes. In addition to avoiding double taxation, there are no payroll tax consequences from paying rents. This is a relative advantage of paying rents to shareholder-employees rather than higher salaries. While both salaries and rents are deductible, salaries also are subject to payroll taxes at rates of as much as 15.3 percent (7.65 percent paid by both the employer and the employee). Moreover, salaries considered "unreasonably high" by the Internal Revenue Service can be recharacterized as dividends resulting in back taxes, interest and possible penalties.

Partially avoid double taxation, reduce payroll taxes, shift income to low-tax-rate family members, protect assets from corporate creditors.

Reasonable rents. Like salaries, rents paid to shareholder-employees also must meet a reasonableness standard. The absolute size of the rental payment is not relevant. A "reasonable rent" is defined as one that a willing lessee would pay to a willing lessor, neither being under any compulsion to enter into the transaction and both having knowledge of the relevant facts.

As a practical matter, as long as the rent can be substantiated by comparable rents charged under comparable circumstances, it will meet the reasonableness standard. If comparables are not available, the rent can be based on a percentage of property value. But, here too, industry norms need to be documented and followed.

Income shifting. Owning real estate outside the corporation also facilitates shifting income from high-tax-rate family members to those subject to low tax rates. This is particularly attractive for families with children age 14 or older who have lower tax rates than their parents.

For example, assume the property generates $100,000 of rental income per year. If 50 percent is owned by a child, $50,000 is taxed at the child's tax rate (an average tax rate perhaps as low as 20 percent) rather than the parents' tax rate (possibly as high as 40 percent)—potentially saving as much as $10,000 per year.

A non-tax advantage of real estate co-ownership with children is to bring them into the family business. (For more information on family ownership of real estate, see the tax column in the spring 1999 issue of *Tierra Grande*, "Tax Planning with Family Limited Partnerships.")

Asset protection. Another advantage for non-corporate real estate ownership is to protect real estate from general creditors of the corporation. If the corporation is involved in legal action, creditors are precluded from attaching assets not owned by the corporation. This result is achieved regardless of whether the real estate is owned by an individual or another business entity, such as a partnership, LLC or S corporation. In addition to real estate, other assets may be owned outside the corporation and provide similar benefits. Examples include vehicles, computers, office equipment and machinery.

Tax planning for the optimal method of real estate ownership can be complex. Consultation with an accountant or attorney regarding specific issues is recommended.

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