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**INCOME TAX – TREATMENT OF RENTAL INCOME AS BUSINESS OR
NONBUSINESS INCOME**

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2017-16. This Revenue Administrative Bulletin (RAB) describes the income tax treatment of rental income or loss¹ for individuals under Part I of the Michigan Income Tax Act (commonly referred to as individual income tax). Specifically, the RAB addresses whether rental income is characterized as business or nonbusiness income.²

INTRODUCTION

A taxpayer with business activity taxable both in Michigan and outside of Michigan must allocate and apportion net income. Whether income is allocable to a particular state or is subject to apportionment amongst the states depends on the characterization of the income as either business or nonbusiness income. Business income is generally apportionable and nonbusiness income is generally allocable. Rental income may be either business or nonbusiness income, depending on the circumstances. Rental income is business income if it arises from transactions, sources, or activities in the regular course of the taxpayer's trade or business.

ISSUES

I. What is rental income?

¹ As used throughout the remainder of this RAB, the term income also refers to and includes loss to the extent that income is negative.

² This RAB does not address Part 2 of the Michigan Income Tax Act, more commonly known as the Corporate Income Tax, which does not distinguish between business and nonbusiness income.

- II. What is the difference between rental activities that give rise to business income and rental activities that are pursued for investment or personal purposes giving rise to nonbusiness income?
- III. When is a taxpayer engaged in a trade or business?
- IV. How does the unitary business principle apply to rental income earned in a multi-state business?
- V. How is nonbusiness rental income treated for income tax purposes?

CONCLUSIONS

- I. Rental income is any income received for the use of real estate or tangible personal property. Rental income is distinct from royalty payments which are receipts from the right to use intangible property such as patents and copyrights or for the extraction of natural resources from real property. This RAB does not address royalties.
- II. Rental income arising from transactions, activities, or sources in the regular course of a taxpayer's trade or business is business income. This includes: 1) income from property where the rental constitutes an integral part of the taxpayer's regular trade or business operations; and, 2) income from isolated or infrequent lease transactions so long as the leased property is or was used in the taxpayer's trade or business operation. Where the taxpayer is not engaged in a trade or business and the income derived from rental activities is for investment or personal purposes, it is nonbusiness income.
- III. A taxpayer is engaged in a trade or business if the taxpayer pursues the activity with continuity and regularity and for the primary purpose of producing income or profit.
- IV. Where an individual, a trust, or an estate derives rental income from a multi-state business conducted partially within this State, a tax is imposed on the apportioned share of income from that business if it is unitary. Rent is a sale for purposes of the sales factor. Taxpayers may elect either separate entity or combined entity apportionment. Intercompany transactions between businesses that are unitary must be eliminated.
- V. Nonbusiness income arising from the rental of real property is allocated to the state in which the property is located. Nonbusiness income arising from the rental of tangible personal property is allocated according to a set of rules which depend primarily on where the property is used and whether the taxpayer is a resident.

LAW AND ANALYSIS

Rental income is any income received for the use of real estate or tangible personal property. Whether that income is assigned entirely to Michigan or divided among Michigan and other states depends on the characterization of that income. Allocation is the term used to refer to the assignment of income to a particular state. Apportionment is the method of dividing income among two or more states using a formula. Under Part I of the Michigan Income Tax Act

(MITA), rental income, to the extent it constitutes nonbusiness income, is allocated to a particular state.³ To the extent it is business income, rental income is apportioned.⁴ The distinction between business and nonbusiness income is therefore critical to the proper characterization and reporting of rental income.

Business Income v Nonbusiness Income

Under the MITA, business income is all income arising from transactions, activities, and sources in the regular course of the taxpayer's trade or business and includes the following:

- (a) All income from tangible and intangible property if the acquisition, *rental*, management, or disposition of the property constitutes integral parts of the taxpayer's regular *trade or business* operations.
- (b) Gains or losses from stock and securities of any foreign or domestic corporation and dividend and interest income.
- (c) Income derived from isolated sales, *leases*, assignment, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions involving property if the property is or was used in the taxpayer's *trade or business* operation.
- (d) Income derived from the sale of a business.⁵

Nonbusiness income is all income other than business income.⁶

Under the MITA, income arising from the rental or lease of property is business income if the rental constitutes an integral part of the taxpayer's regular trade or business, or in the case of an isolated lease or rental, if the property is or was used in the taxpayer's trade or business operation regardless whether it is integral to it. An isolated lease might arise, for instance, when equipment not necessarily integral to the business is occasionally rented out for use by others when it is idle. Because the equipment is or was used in the business, even though the rental of it is occasional or isolated, it is business income.

The first step in determining whether rental income is business income is to determine whether the taxpayer is engaged in a trade or business. If a taxpayer establishes that he or she is engaged in a trade or business, the second step is to identify the relationship of the rental activity to the taxpayer's trade or business. If the rental activity is an integral part of the taxpayer's regular trade or business operations, it is business income. If the rental or lease is an isolated one and not integral to the taxpayer's trade or business, it is still business income if the leased property is or was used in the taxpayer's trade or business operation.

Step 1: *Evaluating Whether a Taxpayer is Engaged in a Trade or Business*

³ MCL 206.110(4); MCL 206.111.

⁴ MCL 206.115.

⁵ MCL 206.4.

⁶ MCL 206.14(1).

The MITA does not define the phrase “trade or business.” Therefore, the Department looks to the definition of trade or business assigned by the federal income tax laws when used in a comparable context.⁷ The phrase “trade or business” appears in over fifty sections and 800 subsections of the Internal Revenue Code (IRC), but none define it.⁸ The Internal Revenue Service (IRS) relies upon the following definition of a trade or business: *[A]n activity carried on for livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. The regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.*⁹ Federal case law as well as Michigan case law has also applied similar versions of this facts and circumstances test.¹⁰ The Department previously adopted this definition of a trade or business in other guidance.¹¹

This facts and circumstances trade or business test adopted by the U.S. Supreme Court in *CIR v Groetzinger* established two requirements for an activity to constitute a trade or business: 1) the taxpayer’s activity or pursuit must be conducted for income or profit; and, 2) the activity or pursuit must be engaged in with some regularity and continuity.¹²

To satisfy the first prong of the *Groetzinger* test, the primary purpose of the rental activity must be to earn income or produce a profit. The fact that no profit was actually earned does not preclude a finding of profit motive where other facts and circumstances establish that the taxpayer has made a serious effort to rent the property, such as where the expenses exceeded the gross receipts or where a unique economic market failed to produce any potential renters.

The following examples highlight the profit motivation prong of the trade or business determination:

Example 1. Individual taxpayer purchases a piece of real property for the purpose of renting it to produce a profit. During the tax years at issue, the taxpayer makes various improvements and repairs to the property, lists the property for rent in local advertisements, shows it to prospective renters, and receives below market rental offers due to slow economic conditions. Taxpayer’s efforts to rent the property are unsuccessful and he earns no income or profit during the tax years at issue. Taxpayer’s failure to earn a profit does not preclude a finding that the taxpayer is engaged in a rental trade or business if taxpayer’s activity otherwise satisfies the second prong of the *Groetzinger* definition. Assuming the same facts except that taxpayer inherits the property, the conclusion is the same even if, after a number of unsuccessful years attempting to rent the property, the taxpayer sells it.

⁷ MCL 206.2(2).

⁸ *CIR v Groetzinger*, 480 US 23, 27 (1987).

⁹ See <https://www.irs.gov/businesses/small-businesses-self-employed/business-activities> and also IRS Publication No. 334.

¹⁰ See *Higgins v CIR*, 312 US 212 (1941) and *Dombrowski v Dep’t of Treasury*, No. 316888, 2014 WL 5364132, at *3 (Mich Ct App October 21, 2014).

¹¹ See RAB 1987-3 and RAB 2016-3.

¹² *CIR v Groetzinger*, 480 US 23, 35 (1987).

Example 2. Individual taxpayer inherits a parcel of rental property that has an existing long-term tenant at the time of inheritance. The taxpayer intends to dispose of the property as soon as possible but continues to lease the property to the existing tenant until a sale can be arranged. Between the time of inheritance and the sale, taxpayer makes no efforts to maintain the property, renew the lease, or seek new tenants. The taxpayer is not engaged in a trade or business because the taxpayer has no intent to earn income or profit from the rental of the property. His intent is to liquidate the property as soon as possible.

Example 3. Individual taxpayer purchases a piece of property which he uses as a vacation home and which he also occasionally rents to family and friends as a courtesy. The rental charges are intended to offset use costs and maintenance. Taxpayer never leases the property to anyone for an extended period and does not hold the property out for rent to the general public. Taxpayer is not engaged in a trade or business with respect to the rental income from the property because he lacks a profit motive. It is also unlikely that he would satisfy the second prong of the trade or business test. However, if the taxpayer purchased the vacation property primarily to earn income from weekly rentals, and he used the property only when unable to rent it, the taxpayer would have a profit motive and would be engaged in a trade or business, assuming he satisfied the second prong of the *Groetzing* test.

The second prong of the *Groetzing* definition requires that a taxpayer, or his agent, participate in the rental activity or pursuit with continuity and regularity. In general, the lower the level of activity that is necessary to realize rental income, the less likely the taxpayer is to be able to satisfy the “regular and continuous participation” prong of the trade or business definition. Continuity and regularity of participation may be satisfied by participating through an agent. A taxpayer leasing a single rental property may be considered to be in a trade or business if the facts establish that the taxpayer or his agent was actively involved in the renting or management of the property on a continuous and regular basis. A taxpayer whose involvement with a rental property is limited to mere collection of rent or other similarly passive activities is not engaged in a trade or business.¹³ Triple-net leases (in which the tenant is responsible for taxes, insurance, repairs, and any operating expenses) generally do not require the lessor’s continuous and regular participation, and a rebuttable presumption arises that the taxpayer/lessor is not engaged in a trade or business.¹⁴

The following non-exhaustive list of factors bears on a determination of a taxpayer’s level of participation with regard to rental income. No one factor by itself is determinative.

- (1) The number of rental properties the taxpayer holds.
- (2) The number of units or tenants within a rental property.
- (3) Whether the lease is a long- or short-term and whether there is a high turnover rate.
- (4) Whether the property is acquired for the purpose of renting it for profit.

¹³ The reference to passive activities in this RAB has no relationship to the federal passive activity loss rules.

¹⁴ See for example IRS Rev Rul 73-522, 1973-2 CB 226 holding that net leases generally do not rise to the level of activity necessary to establish a trade or business.

(5) The extent to which the taxpayer is responsible for repairs, maintenance, improvements, or other tenant services.

(6) The efforts undertaken by the taxpayer to rent the property, such as whether the taxpayer has listed the property for rent or for sale or whether he or she has actively sought new tenants as leases expired.

(7) Whether the taxpayer occupied the property and for how long.

Step 2: Identifying the Relationship between the Rental Activity and the Taxpayer's Trade or Business Operations

Where a trade or business is established, income from rental activity is business income if it falls into one of two categories: 1) the rental of the property is an integral part of the taxpayer's regular trade or business operations; or, 2) in the case of an infrequent or isolated rental transaction, the property is or was used in the taxpayer's trade or business operation.¹⁵ In both categories, the focus is on the relationship of the rental property to the taxpayer's trade or business operations.

A rental activity is an integral part of a taxpayer's regular trade or business if it is used operationally in and materially contributes to the taxpayer's production of business income such that the property becomes interwoven into and inseparable from the taxpayer's business.¹⁶ Whether property materially contributes is not determined by reference to the property's value or percentage of use. Property held for mere financial betterment is not operationally used in the taxpayer's trade or business.

Example 4. Taxpayer is a partner in a construction business which uses equipment such as cranes, tractors and other heavy equipment. The business occasionally rents out the equipment for short periods of time when the equipment is not in use on a particular construction project. The rental income is business income even though the rentals occur on an irregular or infrequent basis because the equipment is used in the taxpayer's trade or business operations.

Example 5. Taxpayer owns a single-member LLC through which she operates a multistate chain of retail stores. She purchases an office building in another state with surplus funds and leases the entire building to a single tenant. Taxpayer has no future plan to use the building in her retail business as the building is not suitable for that purpose. She hires a leasing agent to handle the leasing arrangements with the tenant. The tenant enters into a five-year lease and is responsible for all maintenance and repairs. Taxpayer's only involvement with the property is the collection of rents. The taxpayer owns no other rental properties. The net rental income is not business income of the taxpayer's retail trade or business because it is not used operationally in the taxpayer's trade or business and does not materially contribute to the

¹⁵ MCL 206.4; 2003 PA 52 amended the business income definition in Section 4 of the MITA by specifically defining four types of business income categories within the definition of business income. The purpose of the amendment was to prevent taxpayers from mischaracterizing income as nonbusiness if it arose from isolated transactions or from sales of businesses themselves. See Jason C. Long, TAXATION, 51 Wayne L Rev 901, 921 (2005) and Michigan House Fiscal Agency Bill Analysis, H.B. 4557, 5/1/2003.

¹⁶ See *Hoechst Celanese Corp v Franchise Tax Bd*, 25 Cal 4th 508, 529; 22 P3d 324, 339 (2001) and *Jim Beam Brands Co. v Franchise Tax Bd*, 133 Cal App 4th 514 (2005).

taxpayer's production of income in the retail trade or business. Moreover, the taxpayer is not engaged in the separate trade or business of leasing property because she is not actively involved with the rental property on a continuous and regular basis.

Example 6. Taxpayer is the sole owner and operator of a residential construction business. Taxpayer also owns several multi-unit residential properties that he leases primarily to college students who occupy the properties year-round. The taxpayer uses a management company to handle the leasing and tenant communications. The taxpayer regularly performs maintenance and repairs to the rental properties and provides snowplowing and landscape services. The taxpayer is engaged in two trades or businesses, and the rental income is business income because the property is integral to the rental trade or business in which the taxpayer is regularly engaged.

Example 7. Taxpayer owns and operates a large vineyard and a dozen small cabins, which he rents to employees working at the vineyard. Taxpayer also owns a warehouse that he leases to a single commercial tenant under a five-year triple-net lease. The taxpayer is engaged in the trade or business of growing and harvesting grapes and the rental income received from his employee tenants is business income because the rental of the property is an integral part of the taxpayer's regular trade or business operations. The rental income from the commercial tenant is nonbusiness income because it is earned from property held for mere financial betterment and is not operationally used in the taxpayer's trade or business.

Example 8. Taxpayer constructed a plant for use in its manufacturing business. After twenty years of use, the plant was closed and put up for sale. During the 18 months before a sale could be brokered, the taxpayer leased the plant to others. The rental income is business income because the plant was used in the taxpayer's trade or business operations.¹⁷ If, on the other hand, the taxpayer held the property for an extended period of time after removing it from its operational use for the purpose of selling it at a later date when the surrounding area was projected to be developed into a busy industrial park, then the property would have lost its character as a business asset and the income from any interim rental of it would be nonbusiness income.

Apportionment.

Section 115 of the MITA requires the apportionment of business income using a formula. Prior to January 1, 2012, business income was apportioned using a three-factor formula: sales, property, and payroll. After December 31, 2011, business income is apportioned using a single sales factor formula.¹⁸ MITA defines sales to include all gross receipts of the taxpayer that are not allocated.¹⁹ Rental receipts from a trade or business are sales for purposes of the apportionment factor. For purposes of the sales factor, rental receipts from real property used in a trade or business are in this State if the property is located in this State.²⁰ Rental receipts from tangible personal property are in this State for apportionment purposes if the property is delivered or shipped to a lessee, other than the United States government, within this State or is

¹⁷ MCL 206.4(c).

¹⁸ MCL 206.115.

¹⁹ MCL 206.20(1).

²⁰ See MCL 206.123(a).

shipped from a location in this State and the lessee is either the United States government or the lessee is a taxpayer that is not taxable in their State of residence.²¹

Nonbusiness income

All income from rental activity that does not meet the definitional criteria for business income is nonbusiness income.²² Nonbusiness rental income must be allocated.²³ Nonbusiness income arising from the rental of real property is allocated to Michigan if the property is located in Michigan.²⁴

Nonbusiness income arising from the rental of tangible personal property is allocated to Michigan using the following rules:

1. Rental income from tangible personal property must be allocated to Michigan if and to the extent it is used in Michigan,²⁵ or
2. Rental income must be allocated entirely to Michigan under the following circumstances:
 - a. The taxpayer is a resident partnership, a resident estate, a resident trust, a resident individual or has a commercial domicile in this state, AND
 - b. The taxpayer is not organized under the laws of, or taxable in, the state in which the property is used.²⁶

Residency for an individual means an individual's domicile, which is his or her true, fixed, and permanent home and principal establishment, to which he or she intends to return whenever he or she is absent.²⁷ An estate of a deceased person is a resident estate of Michigan if the deceased was domiciled in Michigan at the time of his or her death. A trust is a resident trust of Michigan if it was created by the will of a person who was domiciled in Michigan at the time of his or her death or if the trust was created by, or consists of property of, a person domiciled in Michigan at the time the trust became irrevocable.

²¹ See MCL 206.122.

²² MCL 206.14.

²³ MCL 206.110(4).

²⁴ MCL 206.111(1).

²⁵ MCL 206.111(2)(a).

²⁶ MCL 206.111(2)(b).

²⁷ MCL 206.18(1)(a).