

Tax Letter

April 2006, Vol 7 - The Single Activity Rule (Tax Trap Part II)

Dear clients and friends:

In February's tax letter, we have discussed the first tax trap concerning rental of real properties. In addition to the self-rental rule trap, there is another trap buried in IRC section 469, which is called the single activity rule. We would like to demonstrate the rule as below:

Appropriate Economic Unit

The regulation states that "one or more...rental activities may be treated as a single activity if the activities constitute an appropriate economic unit." So, how to constitute an appropriate economic unit? In general, the "facts-and-circumstance" test will be needed to determine whether two or more rental activities together constitute an appropriate economic unit. The most important deciding factors are: (1) the similarity between the activities, and (2) the extent of common control and ownership. For example, if a person owns 100% two residential rental properties, these two properties could be claimed as a single activity for purpose of Code Sec. 469.

Tax Trap

Under certain situations, the tax consequences of grouping two or more activities as a single activity under the passive loss rules could have surprising result. Assume Mr. Smith has a full time job with AGI over \$150,000 and solely owns two rental properties. He collects rental incomes without materially managing them. At the end of the year, he found that one property lost \$10,000 and another one made \$5,000 income. His tax preparer combined these two properties as single activity to report a net loss of \$5,000, and since his AGI is over the limit, the \$5,000 loss must be carried over to the next year. After several years, Mr. Smith wants to sell the property that gave him losses every year. Because of the prosperous market, this property has a large capital gain. Losses on this property has been accumulated for the past year as "passive losses", therefore, he thought that he could apply all these losses against the capital gain. However, Code Sec. 469 (g) disallows this deduction. IRS would argue that because Mr. Smith grouped these two properties as one rental activity, therefore, the capital gain from the property sold would be fully taxable. The sale of one property is only a part of a single activity. Annually, the accumulated losses could be used to offset the income generated from the other property, and the rest of losses could be activated when the other property was sold.

Opportunity

On the other hand, the single activity rule can also be beneficial to taxpayers. Assume Mr. Smith is a real estate professional and materially participates in the management of his own two rental properties. His losses from rental properties incurred in the same taxable year can be deducted from his real estate professional business income. In order to demonstrate material participation in managing his properties, Mr. Smith, a real estate professional, has to pass the 500 hours test. If he spent 900 hours in managing one property and 100 hours for the other, he only can pass the test for one property. But if he elects to combine these two properties as a single appropriate economic unit, he can group his two properties as one single activity. Then, the total 1000 working hours will be sufficient to support that he materially participated in a single rental activity. He can classify his rental income or loss as nonpassive income or loss. As such, he will be allowed to combine all his real estate business income with his rental losses. The key is to prove that you are a “material participant”..

In conclusion, the single activity rule has both drawback and advantage. It depends on the taxpayers’ situation. However, when you take advantage of this rule, keep in mind that it comes with a “catch”.

If you need any further information please give us a call at **415-381-0681**, or visit our web site at www.chochan.com.

Sincerely,

Cho F. Chan, CPA, Inc.