

Tax Letter

February 2006, Vol 5 - Self-Rental Rule (Tax Trap Part 1)

Dear clients and friends:

There is a little known tax trap concerning rental of real properties. A recent court ruling (T.R. Carlos, 123TC275) unveiled this trap which is buried in IRC section 469. We would like to demonstrate the rule as follows:

The Self-Rental Rule, Reg. 1.469-2(f)(6), States:

An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity...is rented for use in a trade or business activity...in which the taxpayer materially participates. This passage may be translated into simple English, as follow:

If a taxpayer has rental income from property rented to a business in which the taxpayer materially participates, any net rental income for the year is deemed "nonpassive". On the other hand, if there is a net rental loss, it is considered "passive". For purposes of this self-rental rule the business can be a C corporation, an S corporation, or a partnership.

Let's understand this rule by an example.

Suppose Michael owns two rental properties. One is a ten units residential building, and other one is a warehouse. Michael rents out all ten units to unrelated tenants, but instead of unrelated entities, he rents the warehouse to his own company which he is the owner and president. At the end of the year, he finds out that the residential building has an annual loss of \$10,000, and the warehouse has an annual net income of \$10,000. You would think that Michael can net the residential building loss with the warehouse net income, and reports a net passive income of \$0 for the current year. Not so. Since he is the president of the company, and spent significant time managing it, he is a "material participant". Therefore, the warehouse's net income is deemed nonpassive income and cannot be netted out with the passive loss from the residential building. By reclassifying "passive" income to "active" business income, Michael must report additional \$10,000 as trade or business income, and separately report \$10,000 passive loss. However, if there had been a net loss from the warehouse rental, it is not deemed an active trade or business loss, which means that Michael has a combined \$20,000 passive loss from his rental activities. To reclassify income but not reclassify loss is a trap in the "Self-Rental" Rule. Why? Passive losses from rental activities may or may not be deductible subject to (i) an annual maximum \$25,000 allowance, and (ii) adjusted gross income limitation (for 2005, it is \$100,000).

How to determine if you are a “material participant” in the business that is renting your own property?

There are two criteria:

- a, If you spend substantial time on the business activity.
- b, If your income from that business is significant part of your total income.

You must demonstrate that you failed both criteria to be considered not a “material participant”. Moreover, if your spouse is the “material participant”, in most circumstances you are subjected to the “Self-Rental” Rule. The rule doesn’t require that the owner of the property must be the owner of the business which you “materially participate”.

In summary, the self-rental denies taxpayers the opportunity of leasing property to business entities in which they materially participate, and use the net income from such activities to offset passive losses from other source.

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.