

Rental Real Estate Losses



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Current economic conditions have forced many rental real estate owners to become accustomed to producing taxable losses. However, current tax laws are prohibiting many from realizing those losses in the current year. Per IRC §469(c)(2), rental real estate income is by default classified as passive income. Passive losses can only be used to offset passive income – not ordinary income or portfolio income. Rental real estate owners often find themselves unable to use the losses derived from their rental activities because they do not have passive income to offset the losses against.

The Internal Revenue Code provides two reliefs for passive losses incurred by taxpayers with rental real estate. To qualify for one of these relief provisions, a taxpayer must either actively participate in the rental real estate activities or be classified as a real estate professional. The definitions of these two terms are critical in determining how the rental activity losses are treated by the taxpayer.

Active Participation

A taxpayer who is actively participating in rental real estate will be able to deduct a maximum of \$25,000 in passive activity losses. This provides the taxpayer with an opportunity to offset ordinary and portfolio income with up to \$25,000 of rental real estate losses. This \$25,000 loss begins to be phased out if the taxpayer has \$100,000 of adjusted gross income (AGI) and is completely phased out at \$150,000 of AGI. In order for a taxpayer to be an active participant, they must own at least 10% of the rental property and have substantial involvement in the management of that property. Limited partners are not eligible for active participation status. The \$25,000 loss limitation (or portion thereof) is determined by netting the income and losses from all rental properties in which the taxpayer actively participates.

Materially Participating Real Estate Professional

The second designation that the Internal Revenue Service provides taxpayers is that of a materially participating real estate professional. This status is far more difficult to obtain, but has much more beneficial results for the taxpayer. If the taxpayer is a materially participating real estate professional, all income and losses from rental activities are treated as non-passive income. This allows them to offset ordinary and portfolio income with the total amount of losses from rental activities. In order to qualify as a materially participating real estate professional, the taxpayer must meet very specific requirements. The taxpayer will need to meet the requirements for real estate professional AND the requirements for material participation. An important

distinction is that material participation is a higher standard than the aforementioned active participation and has very different requirements.

- > Real Estate Professional per IRC §469(c)(7)(B)
 - More than 50% of personal services performed by the taxpayer in all trades or businesses during the tax year are performed in **real** property trades or businesses
 - **AND** the taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses.
- > Material Participation
 - Taxpayers must satisfy one of the four requirements* (Reg. §1.469-5T)
 - The taxpayer spends more than 500 hours participating in the activity during the year.
 - The individual is the only one who substantially participates in the activity.
 - The individual spends more than 100 hours participating and no one else spends more hours.
 - The individual meets material participation requirements for any five of the 10 prior tax years.

When determining material participation, the taxpayer may elect to aggregate his/her participation in all of the rental properties when determining if the requirements have been satisfied. If the taxpayer is a limited partner in a pass-through entity, the taxpayer must satisfy either the 1st or 3rd requirement listed above to be considered a material participant. Only if the taxpayer is a five percent owner of a company may he/she include their time as a W2 employee when determining hours and participation.

Once it is determined that the taxpayer meets the requirements to be a real estate professional, the taxpayer needs to make an election on his/her return by attaching a statement. The statement is made pursuant to IRC §469(c)(7)(A) and only needs to be filed once.

The use of the real estate professional relief from passive activity rules has been something the IRS has recently began to scrutinize. Often they will request specific documentation of hours spent working, in the form of a log. Taxpayers are often unable to produce such specific documents resulting in the revocation of their designation. This revocation of the real estate professional designation results in an increased tax liability and often times an assessment of penalties and interest.

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Please contact [Denise Holmes](#) or [Mike Gracik](#) if you believe that you could benefit from either of these passive activity loss reliefs.

*There are seven requirements, of which the taxpayer only needs to meet one. Because of relevance to this topic, only four were included in this article.

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