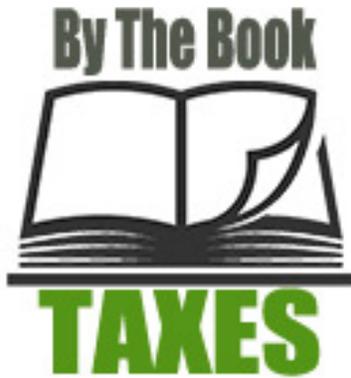




Real Estate Professionals



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Tax Benefits

A taxpayer who spends significant time in activities related to real estate may qualify as a "real estate professional," which can provide tax benefits.

Passive Loss Limits

A passive activity is generally defined as a business activity without a minimum amount of "material participation" by the taxpayer. A taxpayer is not allowed to deduct losses from passive activities in excess of income from passive activities. Any unused losses from passive activities must be carried forward until there are gains from passive activities, or until the passive activities that generated the losses are disposed of.

Special Rules for Real Estate Activities

Under passive loss rules, rental real estate activities are considered passive activities regardless of whether the taxpayer met the definition of "material participation." In other words, for most rental real estate activities, losses in excess of income are not deductible in the year incurred.

Exception for real estate professionals. If a taxpayer qualifies as a real estate professional, passive activity loss limits do not apply to the losses from the taxpayer's rental activities. For a real estate professional, losses may be deducted in the year incurred even if the losses are greater than income.

Qualifying as a real estate professional. A taxpayer will qualify as a real estate professional if the following requirements are met.

- 1) More than half the personal services the taxpayer performed in all trades or businesses during the tax year were performed in real property trades or businesses in which the taxpayer materially participated, and
- 2) The taxpayer performed more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participated.

Personal services performed as an employee do not count unless the taxpayer was a 5% or greater owner of the employer.

Real property trades or businesses include development, construction, acquisition, conversion, rental, operation, management, or brokerage of real property.

Material Participation

Material participation is defined as the taxpayer being involved in the activity on a basis that is "regular, continuous, and substantial." The taxpayer will be considered to materially participate in an activity if:

- 1) The individual worked in the activity for more than 500 hours during the year,
- 2) The individual's participation in the activity constitutes substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity,
- 3) The individual participated in the activity for more than 100 hours during the tax year, and the individual's participation was at least as much as any other individual for the year,
- 4) The activity is a "significant participation activity" for the year (more than 100 hours participation per activity with aggregate of 500 hours),



Real Estate Professionals

- 5) The individual materially participated in the activity for any five (whether or not consecutive) of the ten immediately preceding tax years,
- 6) The activity is a personal service activity and the individual materially participated in the activity for any three preceding tax years, or
- 7) Based on all the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year. This test is not met if the individual participated in the activity for 100 hours or less during the year. Managing the activity does not count for this purpose if any person other than the individual received compensation for managing the activity, or any individual spent more hours during the year managing the activity.

Election to combine rental activities. For purposes of qualifying as a real estate professional, each of the taxpayer's rental activities are treated as separate activities unless the taxpayer elects to treat all interests in rental real estate as a single activity. Failure to make the election can trigger passive loss limits for real estate professionals. To make the election, the taxpayer must file a statement with the original income tax return declaring that he or she is a qualified taxpayer for the taxable year and is making the election to treat all interest in rental real estate as a single rental real estate activity. The election is binding for the taxable year it is made and for all future years whether or not the taxpayer continues to be a qualifying taxpayer. A taxpayer may revoke the election only in the taxable year in which a material change in facts and circumstances occurs.

Example: Leo is a real estate agent who spends more than 750 hours and more than 50% of his time selling real estate. He also owns several rental properties. As a real estate professional, in order for Leo to treat his rental properties as non-passive activities, he would either have to pass the material participation rules for each separate rental property or elect to combine all rentals into one activity and meet the material participation rules as a group.

Court Case: For over 20 years, the taxpayer had been involved in real estate properties. For the years at issue the taxpayer aggregated all rental income and expenses as a single activity on his tax return, but did not attach an election to treat the activities as a single activity. The Tax Court stated that a taxpayer must clearly notify the IRS of the intent to make the election. Without treating the rental properties as one activity, the taxpayer was not able to meet material participation requirements. Net losses were treated as passive losses, and the deductions were not allowed under passive loss rules. (*May*, T.C. Summary 2005-146)

Special \$25,000 Loss Allowance for Rental Real Estate

Regardless of passive loss rules, a taxpayer is allowed to deduct up to \$25,000 in losses from rental real estate if the taxpayer actively participated in the activity. The special loss allowance begins to phase out at incomes above \$100,000.

Married Filing Separately. The phaseout begins at \$50,000 for taxpayers using the filing status of Married Filing Separately. Additional limits apply.

Active participation. Active participation is not the same as material participation. Active participation standards are met if the taxpayer (or taxpayer's spouse) participates in the rental activity in a significant and bona fide sense.

The taxpayer (and/or spouse) must hold at least 10% by value of all interests in the activity during the year.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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