

Woodland Tax Service

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We fix tax problems. Let us help you with yours!

Real Estate Professionals



Tax Benefits

If you spend significant time in activities related to real estate, you 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 you meet 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 you qualify as a real estate professional, passive activity loss limits do not apply to the losses from your rental activities. As 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. You will qualify as a real estate professional if both the following requirements are met.

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

Personal services performed as an employee do not count unless you were 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 being involved in the activity on a basis that is “regular, continuous, and substantial.” You will be considered to materially participate in an activity if:

- 1) You participated in the activity for more than 500 hours during the year,
- 2) Your 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) You participated in the activity for more than 100 hours during the tax year, and your 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),
- 5) You materially participated in the activity for any five (whether or not consecutive) of the 10 immediately preceding tax years,

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- 6) The activity is a personal service activity and you materially participated in the activity for any three preceding tax years, or
- 7) Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the year. This test is not met if you 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 you 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 your rental activities are treated as separate activities unless you elect 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 that do not materially participate in each activity. To make the election, you must file a statement with your original income tax return declaring that you are a qualified taxpayer for the taxable year and are 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 you continue to be a qualifying taxpayer. You 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 nonpassive 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, you are allowed to deduct up to \$25,000 in losses from rental real estate if you actively participated in the activity. The special loss allowance begins to phaseout at incomes above \$100,000.

Real estate professionals are not subject to the passive activity loss limits and can have losses in excess of the \$25,000 special allowance.

Married Filing Separately. If you are married and filing a separate return, the maximum special allowance is \$12,500 and phaseout begins at incomes above \$50,000. If you lived with your spouse at any time during the year, the special allowance is not available.

Active participation. Active participation is not the same as material participation. You actively participated in a rental real estate activity if you and/or your spouse owned at least 10% of the rental property and made management decisions or arranged for others to provide services in a significant and bona fide sense. Management decisions may include approving new tenants, deciding on rental terms, approving expenditures, etc.

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 72.
- 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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