Doing the Math

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For some, it may make sense to try to qualify as a "materially participating real-estate professional." For others, the onerous documentation may not be worthwhile.

Most taxpayers prefer deducting losses to offset against their other income, such as compensation, business income, portfolio income, etc. Often times, landlords ask why they cannot deduct losses from their rental activities. What happens to these losses that they did not get to deduct? For the answer, we must look at Passive Activity Loss Rules.

Passive activity is defined in the Internal Revenue Code (IRC) §469-c(1) as any activity that involves the conduct of trade or business in which the taxpayer does not materially participate. However, rental activity is considered passive regardless of the taxpayer's participation per the IRC §469-c(2). Thus the application of passive activity loss rules limits the use of a passive loss to offset against income such as self-employed business income, salaries or interests and dividends.

In general, passive activity losses are deductible only to the extent of passive activity income. Therefore, many taxpayers with rental properties are challenged with the passive loss limitations unless they qualify for the exceptions to the rules: "active participation" and "materially participating real-estate professional" exceptions. For a materially participating real-estate professional, rental loss deductions are not limited because their rental activities are considered nonpassive. (Qualification criteria for materially participating real-estate professionals are discussed later in this article.)

For San Francisco rental property owners, a combined deduction of mortgage interest, real-estate taxes and depreciation are often not only enough to offset the rental income, but also enough to create rental losses. So what happens to the rental loss that exceeded the rental income?

Just because the rental loss is not deductible to offset other income does not mean taxpayers are in a "use it or lose it" situation. The loss that was not allowed as a deduction is carried forward to future years, until there is passive income to offset or the disposition of the property occurs. However, some losses from rental activities are allowed for deductions under the active participation exception.

Active Participation

To meet the first criteria of the active participation exception test, a taxpayer (alone or together with a spouse) has to own at least 10% of all interests in the rental real-estate activity per IRC §469(i)(6). If a taxpayer's ownership interest in the activity is less than 10%, or if a taxpayer is a limited partner in the partnership, then the taxpayer is not considered to be actively participating in the partnership activity.

The second criteria to the active participation exception is met if the owner-taxpayer participates regularly, making decisions with respect to the rental real-estate activity and continuously managing the property. Management decisions may involve tasks such as choosing contractors for maintenance and repairs of the property, approving new tenants or deciding on rental terms. Once the above tests to the active participation exception are met, up to a $25,000 loss per the IRC §469(i)(2) is allowed for deduction to offset against ordinary income as long as the individual taxpayer's income level is below the $150,000 threshold.

The full benefit of the $25,000 loss deduction is available for individual taxpayers with less than $100,000 of Modified Adjusted Gross Income (MAGI). Taxpayers with a MAGI exceeding $100,000 but below $150,000 get some benefit from deducting the reduced amount of loss. The rental loss deduction is limited to zero for taxpayers with MAGI of $150,000 or more. The suspended loss is then carried forward to future years, until there is passive income to offset or the taxpayer disposes of the property. In the year of disposition, the suspended accumulated losses from the rental property are released for deduction.

Many owners want to know if there is any way to get past the income limitation and be able to deduct any loss. The answer is yes, but with that comes more stringent qualification criteria and documentation requirements. This is the second exception to the passive loss rules, commonly known as the "materially participating real-estate professional" exception.

Materially Participating Real-Estate Professional

Qualification for the materially participating real-estate professional exception is more stringent since the rental loss deduction is not limited by the passive loss rules. The eligibility is also determined on an annual basis because the requirements below may be met in one year and not in other years.

A taxpayer has to meet two tests: the real-estate professional test and the material participation test. Per the IRC§469(c)(7)(B), a taxpayer is considered to be a real-estate professional if he/she meets the following criteria: more than half of the taxpayer's personal services are performed in real property trades or businesses in which the taxpayer materially participates; and more than 750 hours of (actual) services are performed in real property trades or businesses in which the taxpayer materially participates. "Real property trade or business" is defined, under the IRC §469(c)(7)(C), as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business."

Material participation is determined separately for each activity unless an irrevocable election is made. There are seven guidelines determining material participation and only one of the guidelines has to be met.

For a taxpayer like me who works full time in the public accounting field, it would be very difficult to prove that I am a materially participating real-estate professional and that I am therefore entitled to deduct, say, $27,000 of rental loss on my individual tax return. To support this deduction, I would have to be able to produce contemporaneous records (such as time logs) to show that I work more hours in the real-estate trade or business than I do in my full-time accounting job. There just would not be time for sleep! On the other hand, if I were to file married filing joint tax returns with a spouse in the real estate trade or business, it would be much easier because my spouse could have met half the qualifications of the materially participating real estate professional exception.

There could be a situation where a taxpayer is in the real property trade or business but has multiple real property trades or businesses. The taxpayer may not meet the standards for the material participation test for each business. If taking all activities as a whole, the test may be met. In this situation, an election under the Regulation 1.469-9(g) can be made to aggregate all rental activities as a single activity. A word of warning: once made, this election is irrevocable unless there are material changes to the tax situation. Also, the grouped activities must be disclosed.

Qualifying as a materially participating real estate professional can be beneficial in a case where a taxpayer does not have passive income from other activities but significant income from nonpassive activities. But, if the tax savings from the materially participating real estate professional exception is not great, the taxpayer may not consider it. Recordkeeping requirements such as time logs to track participation can be time consuming and burdensome. For this reason, the taxpayer may just consider the active participation exception.

Also, if my rental property is generating income and I have losses from other passive activities, I may not consider the materially participating real-estate professional exception because I will need passive income to offset passive losses. On the other hand, I may consider the materially participating real-estate professional exception to avoid the recent 3.8% net investment income tax.

As you can see, tax rules, exceptions and elections are complex. Plus, everyone's tax situations and financial goals are different. What worked for your friend may not work for your tax situation. For some taxpayers, what worked for them for their 2013 tax year may not be advantageous for their 2014 tax year. It is important to list your financial goals and consult with your advisors.

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