Are you a real estate professional (for tax purposes)?

The identification and proper tax treatment of passive activities is a complex and often misunderstood area of tax law that significantly affects taxpayers involved in rental real estate.

Daniel Rowe

Further complicating passive-activity loss rules is the special tax treatment for individuals who qualify as real estate professionals.

Passive activity loss and rental real estate

Whether an activity is passive or nonpassive typically depends on the taxpayer's level of participation. However, due to their history of use in tax shelters, rental real estate activities are generally considered passive - regardless of participation level.

The distinction between a passive and nonpassive activity is important because under the passive activity loss (PAL) rules, a loss that is considered passive can usually only be used to offset passive income.

Generally, any passive loss that exceeds passive income is suspended and carried forward to be deducted in a future year. There is an exception of up to $25,000 for taxpayers who actively participate in a rental real estate activity. Nonpassive loss on the other hand can offset both passive and nonpassive income.

Qualifying real estate professional

Although rental real estate is generally a passive activity regardless of participation, an exception is available to qualifying real estate professionals.

If certain criteria are met, those professionals can treat some or all of their rental real estate losses as nonpassive. This will allow them to use those losses to offset nonpassive income, including interest and dividends or wages and other earned income.

The individual must be involved in a real property trade or business, which includes development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage. To qualify, the taxpayer must meet the following tests:

1) More than 50 percent of the personal services performed in all trades or businesses during the tax year are performed in real property trades or businesses in which they materially participate.

2) They perform more than 750 hours of service during the tax year in real property trades or businesses in which they materially participate.

These tests have caveats that should be noted. Married taxpayers cannot combine their service hours to satisfy the tests. Either spouse must satisfy them individually. Also, personal services performed as an employee do not count as real estate trade or business services unless the employee owns 5 percent or more of the employer.

Detailed and contemporaneous documentation is key to supporting the contention that a taxpayer satisfies both tests. In an IRS examination the taxpayer will bear the burden of proving their participation level.

Material participation

To be considered material, the participation must be regular, continuous and substantial to the operations of the business. Congress has developed seven specific tests to determine whether a taxpayer materially participates in an activity.

The most commonly used tests are based on participation hours. For example, participating in an activity for 500 hours or more during a tax year will qualify as material participation.

In contrast to the qualifying real estate professional tests discussed above, married taxpayers can combine the activity of both spouses to meet the material participation tests.

Material participation has two functions in determining whether an individual qualifies for the relief provision as a real estate professional.

First, in determining whether the 50 percent or 750-hour tests mentioned above are met, only real property trades or businesses in which the taxpayer materially participates are counted.

Once the tests are met and the taxpayer qualifies as a real estate professional, the special nonpassive treatment only applies to rental real estate activities in which the professional materially participates.

Grouping activities

With the requirements that need to be met for material participation, an obvious problem arises for taxpayers with multiple rental properties. Because each property is considered a separate activity, one must materially participate with regards to each property separately.

If a taxpayer owns three rental properties and uses a property manager, it is unlikely they can participate for 500 hours per year in each activity. Assuming they had 350 hours per property (1,050 hours total) and also worked as an attorney for 1,000 hours per year, they would fail to meet the 50 percent test to qualify as a real estate professional.

Only activities in which they materially participate, which in this case is none of them, count toward the 50 percent test.

To help achieve material participation when owning multiple properties, taxpayers are allowed to group multiple rental real estate interests — including those held through passthrough entities — into a single activity. This is done through an affirmative election that must be made with the tax return for the first year this grouping is desired.

The election is irrevocable unless there are significant changes in circumstance in a future year. By aggregating all of the separate rental activities into a single activity, the taxpayer need only achieve material participation for the group as a whole.

Other considerations

Before deciding to make the aggregation election, potential downsides should be considered.

If the rental properties are producing net income, which is passive, the election is not helpful. The passive income can be used to offset any passive loss from other activities and aggregation may unnecessarily convert that passive income to nonpassive.

Another downside is that suspended passive losses from prior years will not be deductible until substantially all of the activity is disposed of. Selling one of the grouped properties may have previously freed up suspended losses on that property.

Once aggregated though, all of the properties will likely need to be disposed of to deduct suspended losses.

Finally, while aggregating all rental activities into a single activity can accelerate tax deductions, this might not be the best strategy for all taxpayers. While tax law changes are likely between now and 2013, rates are currently scheduled to increase then. Some taxpayers may prefer to reserve deductions for the higher rate years.

To determine the proper and most advantageous strategy, taxpayers involved in real estate activities should consult a tax advisor. Most importantly they should keep detailed records of their hours worked and duties performed. The best tax strategy is useless without the proper documentation to sustain it.

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